

2011 ANNUAL REPORT

HELPING  
AMERICA  
GET BACK  
— *to* —  
BUSINESS



**Heartland**  
FINANCIAL USA, INC.

Founded in 1981, Heartland Financial USA, Inc. is a \$4.31-billion multibank holding company offering uniquely different banking solutions for business and personal clients. Heartland’s independent community banks are chartered in the states of Iowa, Illinois, Wisconsin, New Mexico, Arizona, Montana, Colorado and Minnesota, with a total of 61 banking locations serving 42 communities as well as mortgage loan production offices in California, Idaho, Nevada, Texas and Wyoming.

**Other business lines include:**

- Home mortgage loans – provided by Heartland Mortgage.
- Trust, investment management and retirement plan services – offered through the Wealth Management Group.
- Brokerage and investment services – provided through LPL Financial Institution Services.
- Consumer finance services – provided by Citizens Finance.

The Heartland Vision is to differentiate itself by highlighting its uniqueness as a commercial banking organization supported by a strong retail delivery system. As one of the top 100 U.S.-based domestic bank holding companies in terms of performance and asset size, Heartland delivers high-quality financial products and services to clients in the Midwest and Western United States.

Heartland’s common stock is traded through the NASDAQ® Global Select Market System under the symbol “HTLF.” Complete information about Heartland Financial USA, Inc. is available at [www.htlf.com](http://www.htlf.com).

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## FINANCIAL HIGHLIGHTS

For the years ended December 31, 2009, 2010 and 2011

(Dollars in thousands, except per share data)

| For the Year  | 2009     | 2010      | 2011      |
|---|----------|-----------|-----------|
| Net income  | \$ 6,374 | \$ 23,788 | \$ 28,008 |
| Net income, exclusive of goodwill impairment charge | 19,033   | 25,427    | 28,008    |
| Net income available to common stockholders         | 1,218    | 18,559    | 20,404    |
| Cash dividends, common                              | 6,484    | 6,521     | 6,566     |

| Per Share Data   | 2009    | 2010    | 2011    |
|--|---------|---------|---------|
| Earnings per common share – diluted  | \$ 0.07 | \$ 1.13 | \$ 1.23 |
| Earnings per common share – diluted, exclusive of goodwill impairment charge | 0.85    | 1.23    | 1.23    |
| Cash dividends, common   | 0.40    | 0.40    | 0.40    |
| Book value at December 31  | 14.38   | 15.26   | 16.29   |

| At Year End                        | 2009         | 2010         | 2011         |
|------------------------------------|--------------|--------------|--------------|
| Total assets                       | \$ 4,012,991 | \$ 3,999,455 | \$ 4,305,058 |
| Total loans and leases, receivable | 2,363,002    | 2,364,787    | 2,494,631    |
| Total deposits                     | 3,050,389    | 3,034,048    | 3,210,113    |
| Total common stockholders' equity  | 235,057      | 250,608      | 268,520      |

| Financial Ratios  | 2009   | 2010   | 2011   |
|---|--------|--------|--------|
| Return on average total assets                              | 0.03 % | 0.46 % | 0.50 % |
| Return on average stockholders' equity                      | 0.51   | 7.51   | 7.77   |
| Net interest margin   | 3.99   | 4.12   | 4.16   |
| Average common stockholders' equity to average total assets | 6.32   | 6.13   | 6.45   |
| Total capital to risk-adjusted assets                       | 15.20  | 16.23  | 15.87  |
| Tier 1 leverage ratio                                       | 13.53  | 14.06  | 14.08  |

|    |             |
|----|-------------|
| 11 | \$4,305,058 |
| 10 | \$3,999,455 |
| 09 | \$4,012,991 |

**TOTAL ASSETS**  
(in thousands)

|    |                  |
|----|------------------|
| 11 | \$1.23           |
| 10 | \$1.13 / \$1.23* |
| 09 | \$0.07 / \$0.85* |

**EARNINGS PER COMMON SHARE**

\*Earnings Per Share exclusive of goodwill impairment charge.

I am pleased to take this opportunity to report on the 2011 results for Heartland Financial USA, Inc. For the year, our company made significant progress on many fronts: We maintained our historic record of positive earnings with the highest net income in our 30-year history; four of our subsidiaries recorded their best years ever; and our Board of Directors approved cash dividends of \$0.40 per share, continuing our history of increased or level dividend payments every year since Heartland's inception in 1981.

Dating back to its origins, the essence of Heartland has been its dedication to and support of business in our communities. The organizers of our flagship bank, Dubuque Bank and Trust, and every management team and board for the last 77 years have maintained this commitment. Our roots are firmly planted in the conviction that strong businesses create vibrant communities. And when our communities prosper, our banks in turn share in the prosperity. Therefore, this year's report to stockholders highlights and celebrates the critical role we play in *Helping America Get Back to Business*.

In the following pages, you will meet several successful business clients of our subsidiary banks. These clients' stories illustrate the varied and creative ways in which we help our customers achieve success. Within the stories, you will read how we are making *Great Things Happen* for these clients and discover the exceptional effort we put forth — an effort that goes beyond our competitive banking products and services. The role our employees play in these customer experiences demonstrates their passion for adding value through exceptional customer service, which creates our distinct competitive advantage.

Reviewing Heartland's financial performance for 2011, we were pleased to see net income increase by nearly 18 percent to \$28.0 million compared to \$23.8 million for 2010. Net income available to common stockholders for 2011 was \$20.4 million or \$1.23 per diluted common share compared to \$18.6 million or \$1.13 per diluted common share for the previous year. Throughout the past 2½ years, Heartland has benefitted from an enviable net interest margin exceeding 4.0 percent.

Behind the numbers, we identified four noteworthy trends that contributed to our performance during 2011. We expect each of these will provide positive impetus going forward. First, we made substantial headway in reducing nonperforming loans. This has been and continues to be Heartland's number-one priority. Nonperforming loans ended the year at 2.3 percent of total loans, a decrease of 37 percent from their peak at year-end 2010. Coinciding with this improvement, delinquent loans dropped to their lowest level in over three years.

Second, after three years of sluggishness, loan growth resumed during the second half of the year. This growth may stem in part from an improving economy, but we are also seeing success from our focus on personal sales and outbound calling efforts. As added incentive for loan growth, Heartland joined the Small Business Lending Fund, a program designed by the U.S. Treasury to encourage small business lending by providing capital to select community banks. An increase in qualifying small business and agricultural loans will result in a considerable reduction in our cost of capital over the next four years.

**Lynn B. Fuller**  
Chairman of the Board, President  
and Chief Executive Officer



Third, we experienced continued improvement in our deposit mix. Deposit growth has been robust during this economic downturn, and customers have increased their liquidity by building balances in their checking, savings and money market accounts with a corresponding decrease in time deposits. This enhancement in deposit mix, along with a sustained decline in market rates, resulted in a dramatic reduction in our cost of funds.

The fourth significant trend was in mortgage lending. Throughout the year, the expansion of our residential mortgage lending capabilities gained significant traction. After a full year of operation, our new Heartland Mortgage / National Residential unit has greatly enhanced our mortgage origination capabilities in every Heartland market. Within Heartland's footprint we've added new lending teams in Phoenix, Albuquerque, Denver, Billings and Minneapolis. Outside our footprint, we now serve California, Idaho, Nevada, Texas and Wyoming.

Looking into Heartland's future, we see changes emerging on the banking landscape that will have meaningful implications for our business. To illustrate, new banking regulations coming out of the Dodd-Frank Act will likely have a measurable impact on the financial services industry, forcing further consolidation. We are closely monitoring these new regulations as they develop to both comply and identify the opportunities and threats impacting our industry.

We believe that banks surviving the next five years will have learned how to operate more efficiently. To that end we continuously analyze our infrastructure and introduce new technologies that reduce cost while improving our customers' banking experience.

The current banking environment is also presenting many promising opportunities for expansion. Smaller and midsize banks are realizing the need to spread fixed costs over a larger asset base. This fact, along with the combination of lower bank valuations and increased regulation, has persuaded many smaller banks to begin the search for a strategic partner. Over the years, we have planted many seeds with banks in and near our existing operations. As a result of those efforts, we now have a significant number of merger and acquisition candidates under consideration and new opportunities arising on a regular basis.

In closing, I am encouraged by Heartland's progress in 2011. With most every performance measure moving in a positive direction, there are very good reasons to be optimistic about Heartland's future.

I thank our corporate board and subsidiary bank boards for their vision and commitment to our success; I thank our corporate leaders, bank management teams and employees for ensuring that *Great Things Happen* for our customers; and I thank you for your continued support and investment in Heartland.

Sincerely,

A handwritten signature in black ink, appearing to read "Lynn B. Fuller".

Lynn B. Fuller  
Chairman of the Board  
President and Chief Executive Officer

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“Our banker really listened to what we needed and came back quickly with a very attractive package.”

NICK CHARLES, PRESIDENT

HEARTLAND BY THE NUMBERS

\$4.3  
BILLION  
ASSETS

4.16%  
NET INTEREST MARGIN

MARGIN  
EXCEEDING  
4% FOR 10  
CONSECUTIVE  
QUARTERS

“We want to make a product that tastes good first and foremost.” That’s the mantra of Alive & Kickin’ Pizza Crust of Green Bay, Wisconsin. When this fast-growing food manufacturer opted to enhance product quality with a new plant, they turned to Heartland Business Bank. “We got bids from other banks,” says Nick Charles, President of Alive & Kickin’, “but they all wanted to recapture their money almost immediately.”

That was not the case with Heartland Business Bank, which put together a creative package of conventional and government agency-backed loans. “Heartland Business Bank’s credit package

allows us to expand our capacity without compromising cash flow,” says Charles. “The loan has very generous terms, it puts monthly payments at a level we can afford and it’s very flexible in terms of prepayment options.”

In addition to creative financing, Charles also values Heartland Business Bank’s overall financial strength and commitment to the local business community. “We feel very comfortable with their bankers as individuals,” he says. “They have good names and good reputations in this community – and that really means something.”

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*Alive & Kickin’ Pizza Crust is a full-line manufacturer, producing a wide variety of pizza crusts and related dough products. The company presently employs over 200 people at three facilities.*





LEFT Nick Charles, President, Alive & Kickin' Pizza Crust  
CENTER Craig Aderhold, Market President, Heartland Business Bank  
RIGHT Randy Charles, Chief Executive Officer, Alive & Kickin' Pizza Crust



## "The thing that impresses me most about DB&T is their 'can-do' attitude."

**BRYAN SMITH**, PRESIDENT

HEARTLAND BY THE NUMBERS

92nd  
LARGEST

PUBLICLY HELD U.S. BANK  
HOLDING COMPANY BY SIZE

0

NEVER AN ANNUAL LOSS

RECORD NET  
INCOME FOR 2011

With 40,000 customers in all 50 states, InterceptEFT is a force to be reckoned with in the field of electronic transaction services. The Fargo, North Dakota-based company provides transaction processing services to help large and small businesses manage direct deposits, receivables and credit card transactions.

InterceptEFT relies on Dubuque Bank and Trust as a gateway into the banking industry's payment systems, but there's a lot more to the relationship. "We really view Dubuque's people as consultants rather than bankers," says Bryan Smith, President

of InterceptEFT. "Not only do they help us stay abreast of the constantly changing regulatory environment, they also partner with us to develop new products."

That partnership is yielding some exciting growth opportunities, including at least one product that is currently out for patent. "At DB&T there's a whole different attitude, a whole different atmosphere," says Smith. "They're a lot more responsive than any bank we deal with. That quick response time is critical because it allows us to get into new markets much faster than the competition."

*InterceptEFT offers comprehensive, safe and hassle-free electronic transactions—a seamless transfer of funds—between over 56,000 companies and innumerable payees.*





ABOVE, LEFT TO RIGHT Bryan Smith, President, InterceptEFT  
 Stephanie Ihbe, Senior Vice President, Heartland Financial USA, Inc.  
 Connie Mosier, Vice President, Risk Management, InterceptEFT  
 Renee Bourdeaux, Vice President of Communications and Marketing, InterceptEFT

LEFT Doug Stillings, Senior Vice President, Dubuque Bank & Trust  
 RIGHT Craig Dresser, Chief Executive Officer, InterceptEFT



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“They understand what’s going on in our business much better than some of the bigger banks.”

DAVE JONES, CEO AND OWNER

HEARTLAND BY THE NUMBERS

4  
SUBSIDIARIES  
WITH RECORD EARNINGS  
IN 2011

RANKED  
54th  
OF 139 PUBLICLY  
TRADED BANKS

10 CONSUMER  
FINANCE OFFICES

Phoenix, Arizona-based Midstate Mechanical is in the midst of reinventing the company. With the downturn in construction, Midstate relies on Arizona Bank & Trust as the company expands into new areas like energy-performance management and job-order contracting. “Our new markets and models can be complicated,” says Dave Jones, CEO and owner, “and some banks don’t want to dig into the financing issues. But Arizona Bank & Trust is really flexible, and they get up to speed fast.”

While Midstate relies on Arizona Bank & Trust for standard banking products like credit lines, loans and treasury management, the company also

appreciates the bank’s willingness to stay abreast of its business needs. “With the rapid changes we are experiencing,” says Jones, “they really stay in touch with us.”

Staying in touch may mean quarterly meetings, daily phone calls, sharing new ideas about banking products or arranging financing for Midstate’s customers. It all adds up, says Jones, to a valuable partnership. “Other banks maybe call you once in a while and say ‘How are you doing?’ Once they get the deposits, they kind of put you off to the side. With Arizona Bank & Trust there’s much more of a hands-on relationship.”

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*Midstate Mechanical credits innovation, creativity, technical excellence and expertise in meeting customer needs as the key drivers of success for this Phoenix, Arizona, mechanical-service company.*



LEFT Dave Jones, Chief Executive Officer and Owner, Midstate Mechanical  
RIGHT Troy Norris, Vice President, Commercial Banking, Arizona Bank & Trust



**"I wish I could adequately state how appreciative we are that they understand our business."**

**MARK CAPRIOLA**, GENERAL MANAGER

HEARTLAND BY THE NUMBERS

**3.2**  
BILLION  
TOTAL DEPOSITS

**2.5**  
BILLION  
TOTAL LOANS

**EIGHT STATES**  
61 BANKING OFFICES

Greater Rockford Auto Auction is in the relationship business. The company brings auto dealers together to buy and sell vehicles in an atmosphere that General Manager Mark Capriola describes as "fun, creative and trustworthy."

With thousands of vehicles passing through the auction lanes and large sums of money changing hands every week, Greater Rockford depends on Riverside Community Bank to manage transactions and minimize risk by keeping an eagle eye on any bad checks. "In the course of a year Riverside helps us process more than 50,000

checks, and there's only a handful that we have a problem with," says Capriola. "It amazes people how tight we have that wound down."

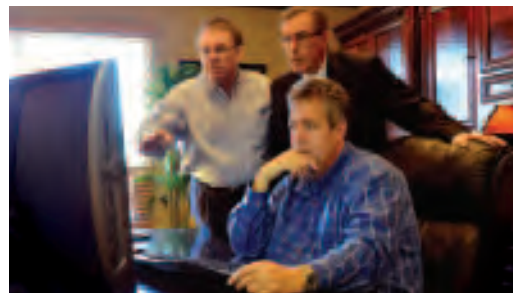
Instant notification about non-sufficient funds helps Greater Rockford minimize risk, but the company also values Riverside's efforts to understand who they are and what they do. "What we like about the people at Riverside is they recognize that our business is different," says Capriola. "They get what we do, they understand our needs and they accommodate us from top to bottom."

*Founded in 1953, Greater Rockford Auto Auction brings auto dealers together to buy and sell vehicles in a fun, creative and trustworthy atmosphere.*





LEFT Mark Clark, Owner, Greater Rockford Auto Auction  
 CENTER Bill Brenner, Vice Chairman, Riverside Community Bank  
 RIGHT Mark Capriola, General Manager, Greater Rockford Auto Auction



“When you’re dealing with Rocky Mountain Bank, you know Heartland’s behind them. But you get the local treatment — and that’s really important.”

STEVE LANGLAS, JR., PRESIDENT

HEARTLAND BY THE NUMBERS

\$28  
MILLION  
NET INCOME

9

INDEPENDENT BANK CHARTERS

31 CONSECUTIVE  
YEARS OF  
INCREASED  
OR LEVEL  
DIVIDENDS

Langlas & Associates — a general contractor with offices in Bozeman and Billings, Montana — has managed to defy the recent recession. With a diverse client base, an expanding geographical footprint and a laser focus on quality, this fast-growing business relies on Rocky Mountain Bank for credit lines and cash management. “They don’t just take your money and sit on it,” says Steve Langlas, Jr., president of the family-owned firm, “they help you find ways to get the best return.”

With large sums of money moving in and out of company accounts, Langlas needs a vigilant banking partner to help manage receivables and disbursements. “We process lots of checks every month,” notes Langlas, “and we need somebody watching our back. Rocky Mountain really bends over backward for us.”

While high-quality banking products are important, Langlas and his team place a higher value on personal service and attention to details. “With some banks, they change officers and you’re shuffled around,” says Langlas. “But with Rocky Mountain we always feel like we’re dealing with the president — even when we’re not.”

Sharing insights — about other industries, economic trends and new banking products — gives Langlas a valuable perspective on his business. “The folks at Rocky Mountain are incredibly proactive,” he says. “They’re always dropping by to share ideas and check on our needs. We know they have our interests at heart, and it’s a very comfortable relationship.”

*Langlas & Associates has been building custom homes for 37 years. In the past they have built lake houses, fishing lodges, river estates and mountain homes all across Montana. The featured photo is a home in Big Sky, Montana. Langlas & Associates did all the interior finish work on this home.*





LEFT Kent Levi, Branch President, Rocky Mountain Bank — Bozeman  
RIGHT Steve Langlas, Jr., President, Langlas & Associates



## BALANCE SHEET HIGHLIGHTS

For the years ended December 31, 2002 through 2011 (Dollars in thousands, except share and per share data)

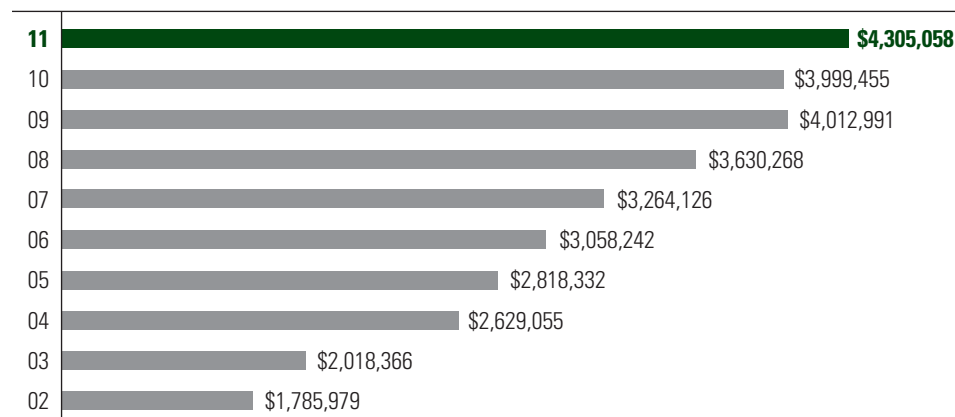
| <b>BALANCE SHEET DATA</b>                           | <b>2002</b>         | <b>2003</b>         | <b>2004</b>         |
|---|---------------------|---------------------|---------------------|
| <b>ASSETS:</b>                                      |                     |                     |                     |
| Cash and due from banks                             | \$ 61,106           | \$ 68,424           | \$ 68,919           |
| Federal funds sold and other short-term investments | 39,886              | 3,445               | 4,830               |
| Cash and cash equivalents                           | 100,992             | 71,869              | 73,749              |
| Time deposits in other financial institutions       | 1,677               | 1,132               | 1,178               |
| Securities  | 390,815             | 451,753             | 553,284             |
| Loans held for sale                                 | 23,167              | 25,678              | 32,161              |
| Gross loans and leases:                             |                     |                     |                     |
| Loans and leases                                    | 1,152,069           | 1,322,549           | 1,772,954           |
| Loans covered by loss share agreements              | —                   | —                   | —                   |
| Allowance for loan and lease losses                 | (16,091)            | (18,490)            | (24,973)            |
| Loans and leases, net                               | 1,135,978           | 1,304,059           | 1,747,981           |
| Assets under operating lease                        | 30,367              | 31,636              | 35,188              |
| Premises, furniture and equipment, net              | 35,591              | 49,842              | 79,353              |
| Intangible assets                                   | 20,929              | 25,236              | 45,536              |
| Other assets  | 46,463              | 57,161              | 60,625              |
| <b>TOTAL ASSETS</b>                                 | <b>\$ 1,785,979</b> | <b>\$ 2,018,366</b> | <b>\$ 2,629,055</b> |

### LIABILITIES AND STOCKHOLDERS' EQUITY

|   |                     |                     |                     |
|---|---------------------|---------------------|---------------------|
| <b>LIABILITIES:</b>                               |                     |                     |                     |
| Deposits:   |                     |                     |                     |
| Demand  | \$ 197,516          | \$ 246,282          | \$ 323,014          |
| Savings   | 511,979             | 569,286             | 750,870             |
| Time  | 628,490             | 676,920             | 909,962             |
| Total deposits                                    | 1,337,985           | 1,492,488           | 1,983,846           |
| Short-term borrowings                             | 161,379             | 176,835             | 231,475             |
| Other borrowings                                  | 126,299             | 173,958             | 196,193             |
| Accrued expenses and other liabilities            | 36,275              | 34,162              | 41,759              |
| <b>TOTAL LIABILITIES</b>                          | <b>1,661,938</b>    | <b>1,877,443</b>    | <b>2,453,273</b>    |
| Preferred stock                                   | —                   | —                   | —                   |
| Common stockholders' equity                       | 124,041             | 140,923             | 175,782             |
| <b>STOCKHOLDERS' EQUITY</b>                       | <b>124,041</b>      | <b>140,923</b>      | <b>175,782</b>      |
| Noncontrolling interest                           | —                   | —                   | —                   |
| <b>TOTAL EQUITY</b>                               | <b>124,041</b>      | <b>140,923</b>      | <b>175,782</b>      |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b> | <b>\$ 1,785,979</b> | <b>\$ 2,018,366</b> | <b>\$ 2,629,055</b> |

### Common Share Data

|  |            |            |            |
|--|------------|------------|------------|
| Book value per common share                | \$ 8.40    | \$ 9.29    | \$ 10.69   |
| Common shares outstanding, net of treasury | 14,769,621 | 15,163,503 | 16,441,058 |



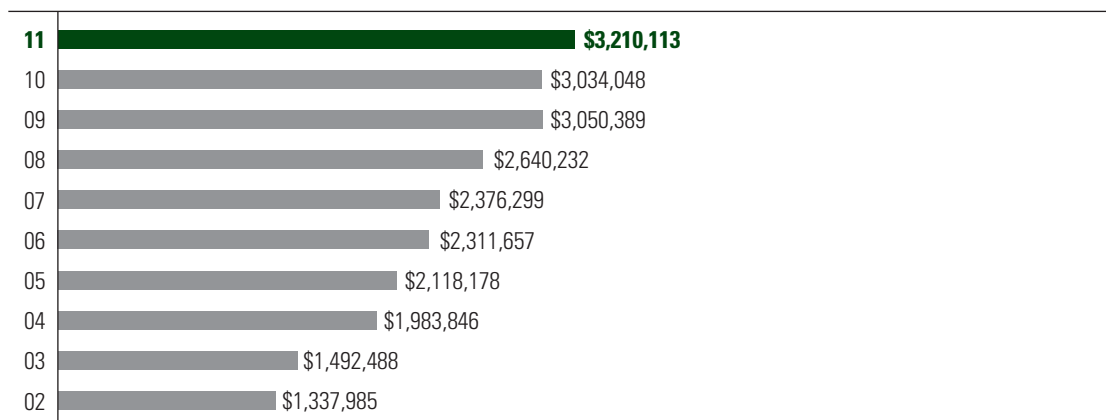
### TOTAL ASSETS

As of December 31 (dollars in thousands)

|           | 2005             | 2006                | 2007                | 2008                | 2009                | 2010                | 2011                |
|-----------|------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| \$        | 40,422           | \$ 47,753           | \$ 46,468           | \$ 48,977           | \$ 177,619          | \$ 58,960           | \$ 126,680          |
|           | 40,599           | 1,390               | 364                 | 2,326               | 4,791               | 3,612               | 3,154               |
|           | 81,021           | 49,143              | 46,832              | 51,303              | 182,410             | 62,572              | 129,834             |
|           | —                | —                   | —                   | —                   | —                   | —                   | —                   |
|           | 527,767          | 617,040             | 689,949             | 903,705             | 1,175,217           | 1,264,564           | 1,326,592           |
|           | 40,745           | 50,381              | 12,679              | 19,695              | 17,310              | 23,904              | 53,528              |
|           | 1,953,066        | 2,147,845           | 2,280,167           | 2,405,001           | 2,331,142           | 2,343,987           | 2,481,284           |
|           | —                | —                   | —                   | —                   | 31,860              | 20,800              | 13,347              |
|           | (27,791)         | (29,981)            | (32,993)            | (35,651)            | (41,848)            | (42,693)            | (36,808)            |
|           | 1,925,275        | 2,117,864           | 2,247,174           | 2,369,350           | 2,321,154           | 2,322,094           | 2,457,823           |
|           | 40,644           | —                   | —                   | —                   | —                   | —                   | —                   |
|           | 92,769           | 108,567             | 120,285             | 120,500             | 118,835             | 121,012             | 110,206             |
|           | 44,557           | 48,827              | 48,576              | 48,286              | 39,928              | 39,375              | 38,869              |
|           | 65,554           | 66,420              | 98,631              | 117,429             | 158,137             | 165,934             | 188,206             |
| <b>\$</b> | <b>2,818,332</b> | <b>\$ 3,058,242</b> | <b>\$ 3,264,126</b> | <b>\$ 3,630,268</b> | <b>\$ 4,012,991</b> | <b>\$ 3,999,455</b> | <b>\$ 4,305,058</b> |

|           |                  |                     |                     |                     |                     |                     |                     |
|-----------|------------------|---------------------|---------------------|---------------------|---------------------|---------------------|---------------------|
| \$        | 352,707          | \$ 371,465          | \$ 381,499          | \$ 383,061          | \$ 460,645          | \$ 580,589          | \$ 737,323          |
|           | 754,360          | 822,915             | 855,036             | 1,128,312           | 1,554,358           | 1,558,998           | 1,678,154           |
|           | 1,011,111        | 1,117,277           | 1,139,764           | 1,128,859           | 1,035,386           | 894,461             | 794,636             |
|           | 2,118,178        | 2,311,657           | 2,376,299           | 2,640,232           | 3,050,389           | 3,034,048           | 3,210,113           |
|           | 255,623          | 275,694             | 354,146             | 210,184             | 162,349             | 235,864             | 270,081             |
|           | 220,871          | 224,523             | 263,607             | 437,833             | 451,429             | 362,527             | 372,820             |
|           | 35,848           | 36,657              | 39,474              | 33,396              | 33,767              | 35,232              | 99,151              |
|           | 2,630,520        | 2,848,531           | 3,033,526           | 3,321,645           | 3,697,934           | 3,667,671           | 3,952,165           |
|           | —                | —                   | —                   | 75,578              | 77,224              | 78,483              | 81,698              |
|           | 187,812          | 209,711             | 230,600             | 230,025             | 235,057             | 250,608             | 268,520             |
|           | 187,812          | 209,711             | 230,600             | 305,603             | 312,281             | 329,091             | 350,218             |
|           | —                | —                   | —                   | 3,020               | 2,776               | 2,693               | 2,675               |
|           | 187,812          | 209,711             | 230,600             | 308,623             | 315,057             | 331,784             | 352,893             |
| <b>\$</b> | <b>2,818,332</b> | <b>\$ 3,058,242</b> | <b>\$ 3,264,126</b> | <b>\$ 3,630,268</b> | <b>\$ 4,012,991</b> | <b>\$ 3,999,455</b> | <b>\$ 4,305,058</b> |

|    |            |            |            |            |            |            |            |
|----|------------|------------|------------|------------|------------|------------|------------|
| \$ | 11.46      | \$ 12.65   | \$ 14.04   | \$ 14.13   | \$ 14.38   | \$ 15.26   | \$ 16.29   |
|    | 16,390,415 | 16,572,080 | 16,427,016 | 16,274,490 | 16,346,362 | 16,425,055 | 16,484,790 |



#### TOTAL DEPOSITS

As of December 31 (dollars in thousands)

## INCOME STATEMENT FINANCIAL HIGHLIGHTS

For the years ended December 31, 2002 through 2011 (Dollars in thousands, except share and per share data)

| STATEMENT OF INCOME DATA  | 2002             | 2003             | 2004             |
|---|------------------|------------------|------------------|
| Interest income   | \$ 100,012       | \$ 99,517        | \$ 120,374       |
| Interest expense  | 41,029           | 37,312           | 43,073           |
| Net interest income   | 58,983           | 62,205           | 77,301           |
| Provision for loan and lease losses   | 3,553            | 4,183            | 4,846            |
| Net interest income after provision for loan and lease losses   | 55,430           | 58,022           | 72,455           |
| Noninterest income  | 15,575           | 22,167           | 23,135           |
| Noninterest expense <sup>(1)</sup>  | 47,557           | 54,704           | 68,425           |
| Income taxes  | 7,279            | 7,990            | 7,556            |
| Income from continuing operations   | 16,169           | 17,495           | 19,609           |
| Discontinued operations:  |                  |                  |                  |
| Income from discontinued operations (including gain on sale of \$2,443 in 2007, \$20 in 2006 and \$2,602 in 2002) | 4,416            | 371              | 1,024            |
| Income taxes  | 1,718            | 147              | 381              |
| Income from discontinued operations   | 2,698            | 224              | 643              |
| Net income  | 18,867           | 17,719           | 20,252           |
| Net income attributable to noncontrolling interest, net of tax  | —                | —                | —                |
| Net income attributable to Heartland  | 18,867           | 17,719           | 20,252           |
| Preferred dividends and discount  | —                | —                | —                |
| <b>Net income available to common stockholders</b>  | <b>\$ 18,867</b> | <b>\$ 17,719</b> | <b>\$ 20,252</b> |

### PER COMMON SHARE DATA

|  |            |            |            |
|--|------------|------------|------------|
| Net income — diluted                                       | \$ 1.28    | \$ 1.16    | \$ 1.26    |
| Income from continuing operations — diluted <sup>(2)</sup> | 1.09       | 1.15       | 1.22       |
| Cash dividends   | 0.27       | 0.27       | 0.32       |
| Dividend payout ratio                                      | 20.81 %    | 23.09 %    | 24.87 %    |
| Diluted weighted average shares outstanding                | 14,783,554 | 15,258,440 | 16,084,557 |

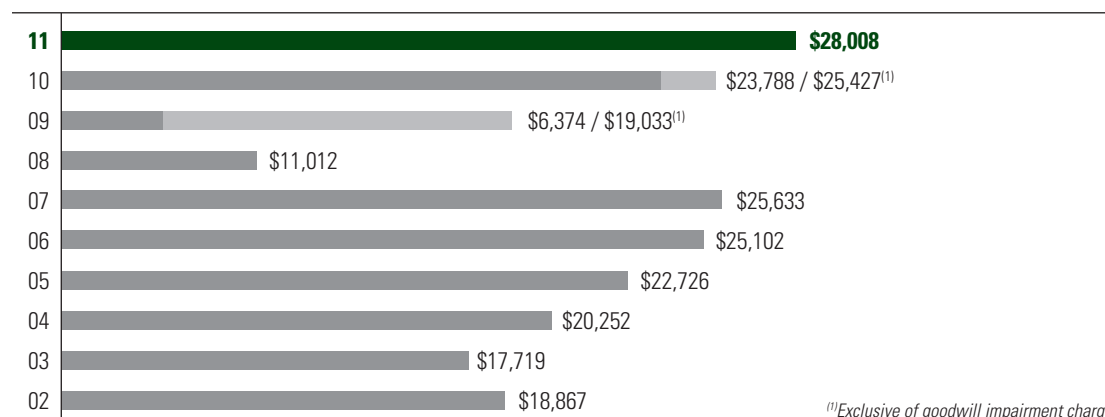
### EARNINGS PERFORMANCE DATA

|   |        |        |        |
|---|--------|--------|--------|
| Return on average total assets          | 1.13 % | 0.95 % | 0.87 % |
| Return on average stockholders' equity  | 16.44  | 13.46  | 12.82  |
| Net interest margin <sup>(2), (3)</sup> | 4.13   | 3.86   | 3.90   |

<sup>(1)</sup> Noninterest expense includes goodwill impairment charge of \$1,639 in 2010 and \$12,659 in 2009.

<sup>(2)</sup> Excludes the discontinued operations of our Broadus branch and the related gain on sale in 2007, Ultea and the related gain on sale in 2006 and operations of our Eau Claire branch and the related gain on sale in 2002.

<sup>(3)</sup> Tax equivalent using a 35% tax rate.

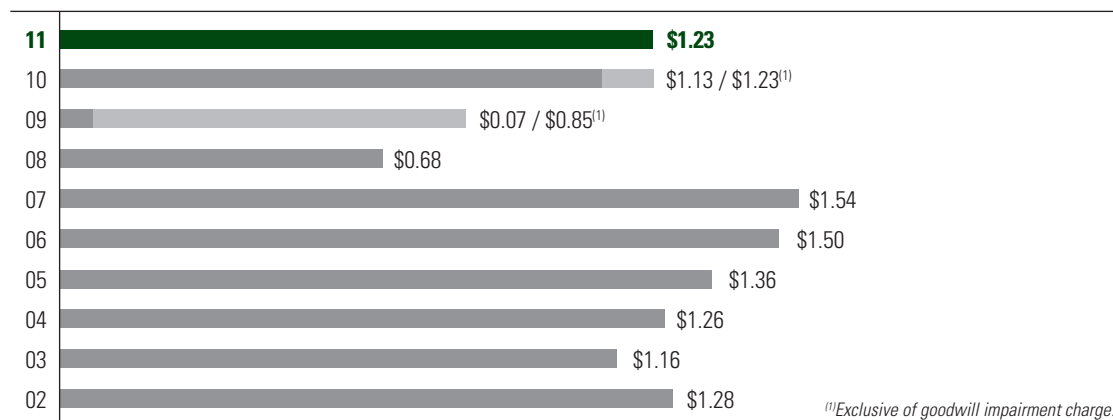


<sup>(1)</sup> Exclusive of goodwill impairment charge.

### NET INCOME

As of December 31 (dollars in thousands)

|           | 2005          | 2006             | 2007             | 2008             | 2009            | 2010             | 2011             |
|-----------|---------------|------------------|------------------|------------------|-----------------|------------------|------------------|
| \$        | 151,489       | \$ 190,150       | \$ 215,231       | \$ 202,585       | \$ 203,293      | \$ 198,932       | \$ 191,737       |
|           | 58,916        | 85,409           | 105,891          | 86,899           | 70,530          | 55,880           | 46,343           |
|           | 92,573        | 104,741          | 109,340          | 115,686          | 132,763         | 143,052          | 145,394          |
|           | 6,533         | 3,883            | 10,073           | 29,319           | 39,377          | 32,508           | 29,365           |
|           | 86,040        | 100,858          | 99,267           | 86,367           | 93,386          | 110,544          | 116,029          |
|           | 25,457        | 29,938           | 31,710           | 30,196           | 52,704          | 52,329           | 59,577           |
|           | 80,285        | 94,943           | 97,606           | 102,239          | 132,520         | 129,239          | 137,296          |
|           | 9,561         | 11,578           | 9,409            | 3,312            | 7,196           | 9,846            | 10,302           |
|           | 21,651        | 24,275           | 23,962           | 11,012           | 6,374           | 23,788           | 28,008           |
|           | 1,664         | 1,758            | 2,756            | —                | —               | —                | —                |
|           | 589           | 931              | 1,085            | —                | —               | —                | —                |
|           | 1,075         | 827              | 1,671            | —                | —               | —                | —                |
|           | 22,726        | 25,102           | 25,633           | 11,012           | 6,374           | 23,788           | 28,008           |
|           | —             | —                | —                | 280              | 188             | 115              | 36               |
|           | 22,726        | 25,102           | 25,633           | 11,292           | 6,562           | 23,903           | 28,044           |
|           | —             | —                | —                | 178              | 5,344           | 5,344            | 7,640            |
| <b>\$</b> | <b>22,726</b> | <b>\$ 25,102</b> | <b>\$ 25,633</b> | <b>\$ 11,114</b> | <b>\$ 1,218</b> | <b>\$ 18,559</b> | <b>\$ 20,404</b> |
| \$        | 1.36          | \$ 1.50          | \$ 1.54          | \$ 0.68          | \$ 0.07         | \$ 1.13          | \$ 1.23          |
|           | 1.30          | 1.45             | 1.44             | 0.68             | 0.07            | 1.13             | 1.23             |
|           | 0.33          | 0.36             | 0.37             | 0.40             | 0.40            | 0.40             | 0.40             |
|           | 23.82 %       | 23.53 %          | 23.60 %          | 58.13 %          | 532.35 %        | 35.14 %          | 32.52 %          |
|           | 16,702,146    | 16,734,989       | 16,596,806       | 16,365,815       | 16,325,320      | 16,461,679       | 16,575,506       |
|           | 0.84 %        | 0.86 %           | 0.81 %           | 0.33 %           | 0.03 %          | 0.46 %           | 0.50 %           |
|           | 12.55         | 12.86            | 11.88            | 4.84             | 0.51            | 7.51             | 7.77             |
|           | 4.03          | 4.17             | 3.95             | 3.89             | 3.99            | 4.12             | 4.16             |



## EARNINGS PER COMMON SHARE

## HEARTLAND LOCATIONS

Heartland Financial Operations Center headquarters located in historic downtown Dubuque, Iowa.



Because we are geographically diverse and practice risk diversification, our growth potential is greater than the limits of any individual market or location.



- ★ Chandler, AZ (2)
- Gilbert, AZ
- Mesa, AZ
- Phoenix, AZ
- Tempe, AZ



- ★ Dubuque, IA (5)
- Epworth, IA
- Farley, IA
- Holy Cross, IA



- Carthage, IL
- ★ Keokuk, IA (2)



- Elizabeth, IL
- ★ Galena, IL (2)
- Stockton, IL

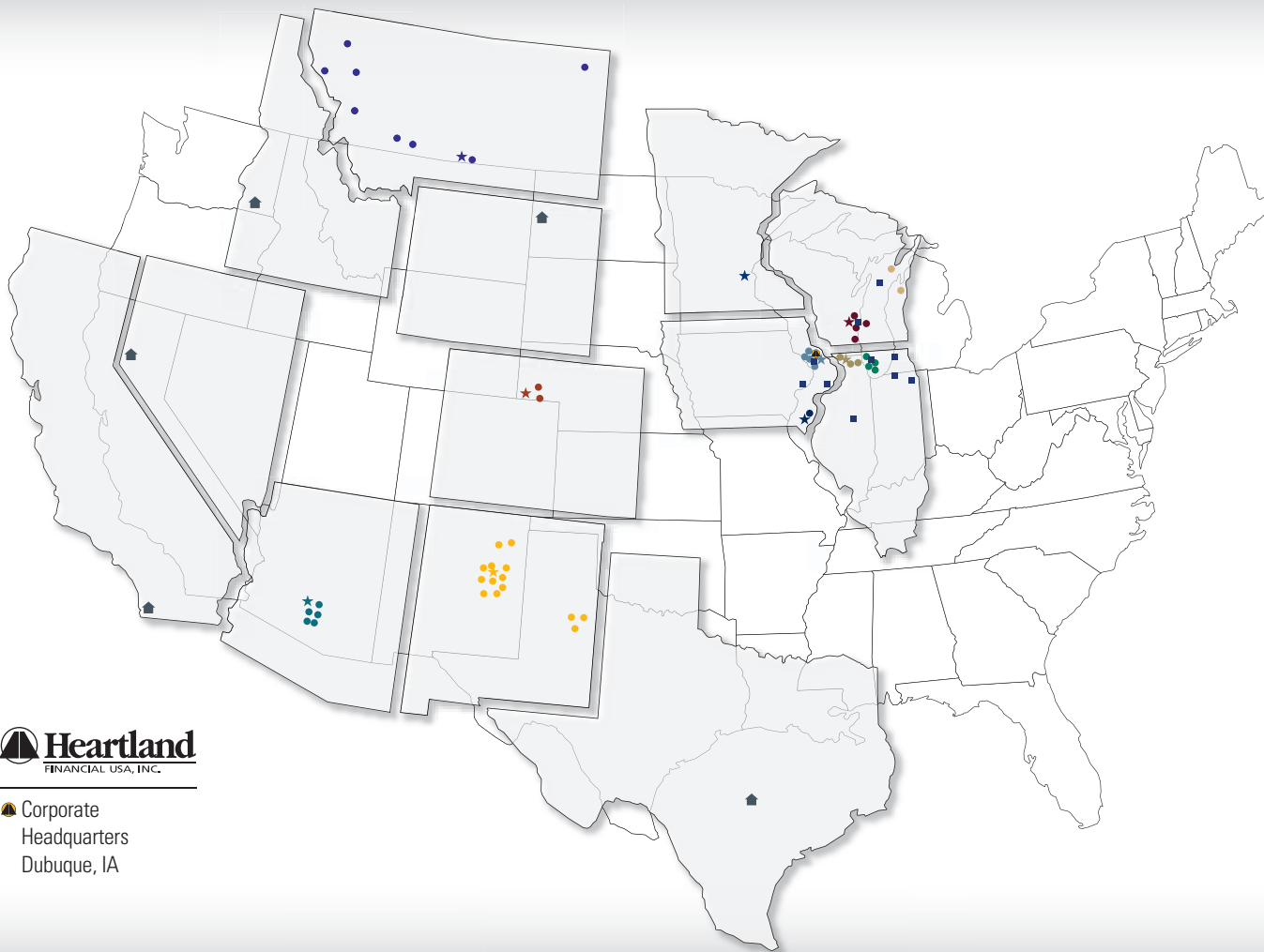


- ★ Minneapolis, MN



- ★ Albuquerque, NM (6)
- Clovis, NM (3)
- Los Lunas, NM
- Melrose, NM
- Portales, NM
- Rio Rancho, NM (2)
- Santa Fe, NM (2)





Corporate  
 Headquarters  
 Dubuque, IA



- Machesney Park, IL
- ★ Rockford, IL (3)



- Bigfork, MT
- ★ Billings, MT (2)
- Bozeman, MT
- Kalispell, MT
- Plains, MT
- Plentywood, MT
- Stevensville, MT
- Whitehall, MT
- Boise, ID
- Buffalo, WY



- ★ Broomfield, CO
- Erie, CO
- Thornton, CO



- Cottage Grove, WI
- Fitchburg, WI
- ★ Madison, WI
- Middleton, WI
- Monroe, WI



- DePere, WI
- Sheboygan, WI



- Appleton, WI
- Aurora, IL
- Cedar Rapids, IA
- Crystal Lake, IL
- Davenport, IA
- Dubuque, IA
- Loves Park, IL
- Madison, WI
- Peoria, IL
- Tinley Park, IL



- Austin, TX
- Reno, NV
- San Diego, CA

## HEARTLAND FINANCIAL USA, INC. DIRECTORS AND EXECUTIVES

### DIRECTORS

**Lynn B. Fuller**

Chairman of the Board, President and Chief Executive Officer, Heartland Financial USA, Inc.

**James F. Conlan**

Partner; Member of Executive Committee of Sidley Austin LLP; Co-Chairman of the Firm-Wide Corporate Reorganization Practice of Sidley Austin LLP, Chicago, Illinois

**John W. Cox, Jr.**

Attorney at Law, Cox Law Offices; Vice President of External Affairs and General Counsel, Jo-Carroll Energy, Inc. (NFP), Elizabeth, Illinois

**Mark C. Falb**

Chairman of the Board and Chief Executive Officer, Kendall Hunt Publishing Company and Westmark Enterprises, Inc., Dubuque, Iowa; Chairman of the Board, Dubuque Bank and Trust Company

**Thomas L. Flynn**

Retired President and Chief Executive Officer, Flynn Ready-Mix Concrete Co., Dubuque, Iowa

**James R. Hill**

President of Hill Companies, LLC, Englewood, Colorado; Chairman of the Board, Summit Bank & Trust

**John K. Schmidt**

Executive Vice President, Chief Operating Officer and Chief Financial Officer, Heartland Financial USA, Inc.

### EXECUTIVES

**Lynn B. Fuller**

President and Chief Executive Officer

**John K. Schmidt**

Executive Vice President, Chief Operating Officer, Chief Financial Officer

**Kenneth J. Erickson**

Executive Vice President, Chief Credit Officer

**John J. Berg**

Executive Vice President, Marketing/Sales

**Brian J. Fox**

Executive Vice President, Operations

**Mel E. Miller**

Executive Vice President, Chief Investment Officer

**Bruce C. Rehmke**

Executive Vice President, Wealth Management Group, Transfer Agent

**Rodney L. Sloan**

Executive Vice President, Chief Risk Officer

**Frank E. Walter**

Executive Vice President, Commercial Sales

**Michael J. Coyle**

Senior Vice President, Senior General Counsel

**David L. Horstmann**

Senior Vice President, Finance

**Douglas J. Horstmann**

Senior Vice President, Lending

**M. Stephanie Ihbe**

Senior Vice President, Treasury Management

**Jacquie M. Manternach**

Senior Vice President, Finance

**Janet M. Quick**

Senior Vice President, Chief Accounting Officer

**Lois K. Pearce**

Senior Vice President, Corporate Secretary

**Nancy M. Wilson**

Senior Vice President, Human Resources

## SUBSIDIARY DIRECTORS AND PRESIDENTS

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### Dubuque Bank and Trust Company

Mark C. Falb \*  
Douglas J. Horstmann •  
Richard C. Cody  
James F. Conlan  
Patrick M. Crahan  
Paul E. DeLong, DMD  
James R. Etheredge  
Thomas L. Flynn  
Donnelle M. Fuerste  
Lynn B. Fuller  
James P. Gantz  
Charles D. Glab  
R. Michael McCoy  
Robert D. McDonald II  
John K. Schmidt

### First Community Bank

#### Advisory Board

John H. Smith \*  
James E. Hanks •  
Robert C. Carson  
Douglas J. Horstmann  
Joseph W. Kamps  
Dr. Michael A. Klauser  
Richard D. Logsdon  
Paul D. Long  
Mary Ellen Pfeifer

### Galena State Bank & Trust Co.

Jerry L. Murdock \*  
Andrew E. Townsend •  
Todd B. Colin  
John W. Cox, Jr.  
Melvin L. Gratton  
Terrance S. Heim  
David F. Jansen  
Martin H. Johnson  
Dan G. Loeschner  
John K. Schmidt  
James B. Vincent  
Pamela K. Wheelwright  
Laurel S. Wurster

### Riverside Community Bank

Dan G. Loeschner \*  
Steven E. Ward •  
Thomas E. Belmont  
Willard C. Brenner  
Michael K. Broski  
Steven J. Elsberg  
Craig A. Erdmier  
Burkhard Geissler  
Scott A. Hendee  
Jeffrey S. Hultman  
Pamela R. Maher  
Michael J. Rogers  
John K. Schmidt  
Andrew E. Townsend  
Jean E. Vitale

### Wisconsin Community Bank

Thomas J. Wilkinson \*  
Kevin S. Tenpas •  
Charles J. Dearth  
John K. Faust  
James L. Finley  
Lynn B. Fuller  
Vernon J. Jesse  
J. Cory Recknor  
Robert A. Reffue  
Susan M. Schmitz  
Steven F. Streff  
Larry A. Swalheim  
Marshall D. (Bub) Zwygart

### New Mexico Bank & Trust

Nadyne C. Bicknell \*  
R. Greg Leyendecker •  
Lynn B. Fuller  
Dan Hardisty  
Sherman McCorkle  
Michael Mechenbier  
Ben F. Spencer  
Randy Ware

### Arizona Bank & Trust

Paul F. Muscenti \*  
Jerry L. Schwallier •  
Lynn B. Fuller  
David B. Jones  
Thomas P. Keig  
Ronald A. Larson  
R. Greg Leyendecker  
Richard K. Ostrom  
Frank E. Walter

### Rocky Mountain Bank

Wallace E. Anderson \*  
Danny T. Skarda •  
Lynn B. Fuller  
Greg C. McDonald

### Summit Bank & Trust

James R. Hill \*  
Frank E. Walter •  
David J. A. Flowers  
Lynn B. Fuller  
Neil A. Littmann  
W. Scott Reichenberg  
Danny T. Skarda  
John M. Spanich

### Minnesota Bank & Trust

Steven M. Thul \*  
Catherine T. Kelly •  
Timothy S. Clark  
Lynn B. Fuller  
Blake R. Nelson  
Duane E. White

### Citizens Finance Co.

Lynn B. Fuller \*  
Al H. Green •  
James F. Conlan  
Kenneth J. Erickson  
Mark C. Falb  
Thomas L. Flynn  
John K. Schmidt

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\* Board Chair

• President

## CORPORATE AND INVESTOR INFORMATION

### Corporate Profile

Mailing Address:  
Heartland Financial USA, Inc.  
1398 Central Avenue  
P.O. Box 778  
Dubuque, Iowa 52004-0778  
Telephone: (563) 589-2100

### Independent Auditors

KPMG LLP  
Des Moines, Iowa

### Corporate Counsel

Dorsey & Whitney LLP  
Minneapolis, Minnesota

### Annual Meeting

The Board of Directors of Heartland Financial USA, Inc. has established Wednesday, May 16, 2012, at 6:00 p.m. Central Daylight Time as the date of the Annual Meeting of Stockholders. We invite all stockholders to attend the meeting, which will be held at the Grand River Center, 500 Bell Street, Dubuque, Iowa.

### Transfer Agent/Stockholder Services

Inquiries related to stockholder records, stock transfers, changes of ownership, change of address and dividend payments should be sent to the transfer agent at the following address:

Heartland Financial USA, Inc.  
c/o Bruce Rehmke, Executive Vice President and Transfer Agent  
Wealth Management Group  
1398 Central Avenue  
P.O. Box 778  
Dubuque, Iowa 52004-0778

### Stock Listing

Heartland's common stock is traded on the NASDAQ® Global Select Market System under the symbol "HTLF."

### Form 10-K and Other Information

The company submits an annual report to the Securities and Exchange Commission on Form 10-K. Stockholders may obtain copies of our Form 10-K without charge by writing to Lois K. Pearce, Senior Vice President and Corporate Secretary, Heartland Financial USA, Inc., 1398 Central Avenue, P.O. Box 778, Dubuque, Iowa 52004-0778. The Form 10-K is also available on the Heartland website under the heading Investor Relations. Securities analysts and other investors seeking additional information about Heartland should contact John K. Schmidt, Executive Vice President, Chief Operating Officer and Chief Financial Officer, at the above address or call him at (563) 589-1994. Additional information is also available at [www.htlf.com](http://www.htlf.com).

### Dividend Reinvestment and Stock Purchase Plan

Heartland Financial USA, Inc. offers stockholders of record a simple and convenient method of increasing holdings in our company by participating in Heartland's Dividend Reinvestment and Stock Purchase Plan. Participants can directly reinvest dividends and make optional cash purchases to acquire additional shares. They may elect to reinvest dividends on either all or a portion of the shares they hold. Participants may also elect to purchase shares of common stock by making optional cash payments of not less than \$150 or more than \$25,000 per quarter. For additional information regarding the Plan, or to request a copy of the Plan's prospectus, please call (888) 739-2100, ext. 2517 or (563) 584-2517.

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

**FORM 10-K**

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2011

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)

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

Title of Class

Common Stock \$1.00 par value

Preferred Share Purchase Rights

Name of Each Exchange on Which Registered

The NASDAQ Global Select Market

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

None

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

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

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

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

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

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

Large accelerated filer ☐ Accelerated filer ☒ 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 in Exchange Act Rule 12b-2). Yes ☐ No ☒

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant, based on the last sales price quoted on the NASDAQ Global Select Market on June 30, 2011, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$214,440,628.

As of March 14, 2012, the Registrant had issued and outstanding 16,501,560 shares of common stock, \$1.00 par value per share.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement for the 2012 Annual Meeting of Stockholders are incorporated by reference into Part III.

**HEARTLAND FINANCIAL USA, INC.**  
**Form 10-K Annual Report**  
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## **PART I**

### **ITEM 1.**

#### **BUSINESS**

##### **A. GENERAL DESCRIPTION**

Heartland Financial USA, Inc. ("Heartland") is a multi-bank holding company registered under the Bank Holding Company Act of 1956, as amended (the "BHCA") that was originally formed in the State of Iowa in 1981 and reincorporated in the State of Delaware in 1993. Headquartered in Dubuque, Iowa, Heartland has nine bank subsidiaries in the States of Iowa, Illinois, Wisconsin, New Mexico, Arizona, Montana, Colorado and Minnesota, (collectively, the "Bank Subsidiaries"). All nine Bank Subsidiaries are members of the Federal Deposit Insurance Corporation (the "FDIC"). The Bank Subsidiaries listed below operate a total of 61 banking locations:

- Dubuque Bank and Trust Company, Dubuque, Iowa, is chartered under the laws of the State of Iowa. Dubuque Bank and Trust Company has two wholly-owned subsidiaries: DB&T Insurance, Inc., a multi-line insurance agency and DB&T Community Development Corp., a partner in low-income housing and historic rehabilitation projects.
- Galena State Bank & Trust Co., Galena, Illinois, is chartered under the laws of the State of Illinois.
- Riverside Community Bank, Rockford, Illinois, is chartered under the laws of the State of Illinois.
- Wisconsin Community Bank, Madison, Wisconsin, is chartered under the laws of the State of Wisconsin.
- New Mexico Bank & Trust, Albuquerque, New Mexico, is chartered under the laws of the State of New Mexico.
- Rocky Mountain Bank, Billings, Montana, is chartered under the laws of the State of Montana.
- Arizona Bank & Trust, Phoenix, Arizona, is chartered under the laws of the State of Arizona.
- Summit Bank & Trust, Broomfield, Colorado, is chartered under the laws of the State of Colorado.
- Minnesota Bank & Trust, Edina, Minnesota, is chartered under the laws of the State of Minnesota.

Heartland has two active non-bank subsidiaries as listed below:

- Citizens Finance Co. is a consumer finance company with offices in Iowa, Illinois and Wisconsin.
- Heartland Community Development Inc. is a property management company with a primary purpose of holding and managing certain nonperforming assets acquired from the Bank Subsidiaries.

In addition, Heartland has issued trust preferred securities through six special purpose trust subsidiaries formed for the purpose of offering the cumulative capital securities, including Heartland Financial Statutory Trust III, Heartland Financial Statutory Trust IV, Heartland Financial Statutory Trust V, Heartland Financial Statutory Trust VI, Heartland Financial Statutory Trust VII and Rocky Mountain Statutory Trust I.

Heartland's subsidiaries are wholly owned, except for Minnesota Bank & Trust, of which Heartland owned 80% of the capital stock on December 31, 2011.

At December 31, 2011, Heartland had total assets of \$4.3 billion, total loans of \$2.5 billion and total deposits of \$3.2 billion. Heartland's total capital as of December 31, 2011, was \$350.2 million. Net income available to common stockholders for 2011 was \$20.4 million.

The principal business of our Bank Subsidiaries consists of making loans to and accepting deposits from businesses and individuals. Our Bank Subsidiaries provide full service commercial and retail banking in their communities. Both our loans and our deposits are generated primarily through strong banking and community relationships, and through management that is locally active. Our lending and investment activities are funded primarily by core deposits. This stable source of funding is achieved by developing strong banking relationships with customers through value-added product offerings, market pricing, convenience and high-touch service. Deposit products, which are insured by the FDIC to the full extent permitted by law, include checking and other demand deposit accounts, NOW accounts, savings accounts, money market accounts, certificates of deposit, individual retirement accounts, health savings accounts and other time deposits. Loans include commercial and industrial, agricultural, real estate mortgage, consumer, home equity and lines of credit.

We supplement the local services of our Bank Subsidiaries with a full complement of ancillary services, including trust and wealth management services, investment services and insurance services. We provide convenient electronic banking services and client access to account information through business and personal online banking, bill payment, remote deposit capture, treasury management services, VISA debit cards and automated teller machines.

## Operating Strategy

Heartland's operating strategy is to maximize the benefits of a commercial banking model by:

1. Creating strong community ties through local bank delivery.
  - Deeply rooted local leadership and boards
  - Local community knowledge and relationships
  - Local decision-making
  - Independent charters
  - Locally recognized brands
  - Commitment to an exceptional customer experience
2. Providing extensive resources to increase revenue.
  - Full range of commercial products, including government guaranteed lending and treasury management services
  - Convenient and competitive retail products and services
  - Extensive menu of wealth management, investment services, insurance, leasing, mortgage and consumer finance
  - Unique approach to consultative relationship building
  - Assistance with management of funding costs
3. Centralizing back-office operations for efficiency.
  - Leverage expertise across all Bank Subsidiaries
  - Leading edge technology for account processing and delivery systems
  - Efficient back-office support for loan processing and deposit operations
  - Centralized loan underwriting and collections
  - Centralized loss management and risk analysis

We believe the personal and professional service offered to customers provides an appealing alternative to the "megabanks" resulting from mergers and acquisitions in the financial services industry. While we employ a community banking philosophy, we believe our size, combined with our complete line of financial products and services, is sufficient to effectively compete in our respective market areas. To remain price competitive, we also believe that we must manage expenses and gain economies of scale by centralizing back office support functions. Although each of our Bank Subsidiaries operates under the direction of its own board of directors, we have standard operating policies regarding asset/liability management, liquidity management, investment management, lending and deposit structure management.

Another component of the operating strategy is to encourage all directors, officers and employees to maintain a strong ownership interest in Heartland. We have established ownership guidelines for executive management and have made an employee stock purchase plan available to employees since 1996. As of December 31, 2011, approximately 21% of Heartland's outstanding common stock was directly registered in the name of our employees, officers, and directors.

We maintain a strong community commitment by supporting the active participation of our employees, officers and board members in local charitable, civic, school, religious and community development activities.

## Acquisition and Expansion Strategy

Our primary strategies are to increase profitability and diversify our market area and asset base by expanding existing subsidiaries through acquisitions and to grow organically by increasing our customer base in the markets we serve. In the current environment, we are seeking opportunities for growth through both FDIC facilitated acquisitions and non-assisted transactions. Although we are focused on opportunities in our current markets and near adjacent markets, we would consider acquisitions in a new market if it fits our business model and would be immediately additive to earnings. We typically consider acquisitions of established financial services organizations, primarily commercial banks or thrifts. We have also formed *de novo* banking institutions in locations determined to have market potential and management with banking expertise and a philosophy similar to our own philosophy.

In recent years, we have focused on markets with growth potential in the Midwestern and Western regions of the United States. In August 2003, Heartland and a group of investors opened Arizona Bank & Trust, a *de novo* banking operation, followed with

a second location in 2004 and a third location in 2005. In 2006, Arizona Bank & Trust expanded by acquiring Bank of the Southwest, a financial institution providing retail and commercial banking services in Phoenix and Tempe, Arizona. A sixth location was opened in 2007.

We acquired Rocky Mountain Bancorporation, Inc., the one-bank holding company of Rocky Mountain Bank in June 2004. Headquartered in Billings, Montana, Rocky Mountain Bank has nine branch locations throughout the state.

In November 2006, we opened Summit Bank & Trust, a *de novo* banking operation in Broomfield, Colorado. In 2007, Summit Bank & Trust opened two additional locations.

One of Heartland's strategic goals is to expand its presence in the Western markets to 50% of its total assets, thereby balancing the growth in its Western markets with the stability of the Midwestern markets. As of December 31, 2011, Heartland had approximately 40% of its assets in Western markets.

In April 2008, we opened Minnesota Bank & Trust in Edina, Minnesota. The capital structure of Minnesota Bank & Trust was very similar to that used with our other *de novo* banks. Heartland provided 80% of the \$16.5 million initial capital and the remaining 20% was provided by a group of local investors.

In July 2009, Galena State Bank & Trust Co. acquired the deposits of The Elizabeth State Bank in Elizabeth, Illinois in a whole bank with loss sharing transaction facilitated by the FDIC. In addition to assuming all of the deposits of the failed bank, Galena State Bank & Trust Co. purchased \$53.6 million of assets.

## **Lending Activities**

### **General**

The Bank Subsidiaries provide a range of commercial and retail lending services to businesses and individuals. These credit activities include agricultural, commercial, residential and consumer loans.

The Bank Subsidiaries market their services to qualified lending customers. Lending officers actively solicit the business of new companies entering their market areas as well as long-standing members of the Bank Subsidiaries' respective business communities. We believe that our Bank Subsidiaries are successful in attracting new lending customers in their markets through professional service, competitive pricing, innovative structures, convenient locations and customer communications.

### **Commercial Loans**

The Bank Subsidiaries have a strong commercial loan base generated primarily through contacts and relationships in the communities they serve. The current portfolios of the Bank Subsidiaries reflect the businesses in those communities and include 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.

Many of the businesses in the communities we serve are small to mid-sized businesses, and commercial lending to small businesses has been, and continues to be an emphasis for our Bank Subsidiaries. Wisconsin Community Bank, Rocky Mountain Bank and New Mexico Bank & Trust are each designated as a Preferred Lender by the U.S. Small Business Administration (SBA). These three banks, along with Riverside Community Bank, are also designated as SBA Express Lenders. Additionally, Wisconsin Community Bank has been granted USDA Certified Lender status for the USDA Rural Development Business and Industry loan program and, in combination with our other Bank Subsidiaries, was the fourth largest lender in the nation for this program during 2010. We believe that these guaranteed loans help the communities in which we operate and provide us with a source of income and solid future lending relationships with local businesses as they grow and prosper.

Our 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. We value the collateral for most of these loans and leases based upon its liquidation value and require personal guarantees in most instances. 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.

In order to limit underwriting risk, we attempt to ensure that all loan personnel are well trained. We use the RMA Diagnostic Assessment in assessing the credit skills and training needs for our credit personnel and have developed specific individualized training. All new lending personnel are expected to complete a similar diagnostic training program. We assist all of the commercial and agricultural lenders of our Bank Subsidiaries in the analysis and underwriting of credit through centralized staff in the credit administration department.

Although the lending personnel of our Bank Subsidiaries report to their respective board of directors each month, we use an internal loan review function to analyze credits of our Bank Subsidiaries and provide periodic reports to those boards of directors. We have attempted to identify problem loans at an early date and to aggressively seek resolution of these situations.

The downturn in the overall economy has negatively impacted Heartland's overall asset quality since 2008. In response, we have developed an internal Special Assets group to focus on resolving problem assets. All commercial or agricultural loans in a default or workout status are assigned to the Special Assets group. Special Assets personnel are also responsible for marketing repossessed properties and meet with representatives from each bank on a monthly basis.

### **Agricultural Loans**

Agricultural loans are emphasized by those Bank Subsidiaries with operations in and around rural markets, including Dubuque Bank and Trust Company, Rocky Mountain Bank, Wisconsin Community Bank's Monroe banking center and New Mexico Bank & Trust's Clovis banking offices. Dubuque Bank and Trust Company is one of the largest agricultural lenders in the State of Iowa. Agricultural loans constituted approximately 11% of our total loan portfolio at December 31, 2011. In making agricultural loans, we have policies designating a primary lending area for each Bank Subsidiary, in which a majority of its agricultural operating and real estate loans are made. Under this policy, loans in a secondary market area must be secured by real estate.

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, the lending personnel of our Bank Subsidiaries 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. The Bank Subsidiaries also work closely with governmental agencies, including the Farm Services Agency, to help agricultural customers obtain credit enhancement products such as loan guarantees or interest assistance.

### **Residential Real Estate Mortgage Loans**

Mortgage lending remains a focal point for Heartland as we continue to build our residential real estate lending business. As long-term interest rates have remained at relatively low levels during the past several years, many customers elected mortgage loans that are fixed rate with fifteen or thirty year maturities. We usually sell these loans into the secondary market and retain servicing on the loans sold to Fannie Mae. We believe that mortgage servicing on sold loans provides a relatively steady source of fee income compared to fees generated solely from mortgage origination operations. Moreover, the retention of servicing provides an opportunity to maintain regular contact with mortgage loan customers. At December 31, 2011, total residential real estate mortgage loans serviced for others totaled \$1.54 billion.

As with agricultural and commercial loans, we encourage participation in lending programs sponsored by U.S. government agencies when justified by market conditions. Loans insured or guaranteed under programs through the Veterans Administration (the "VA") and the Federal Home Administration (the "FHA") are offered at all of the Bank Subsidiaries.

Late in 2010, we announced a significant addition to our residential mortgage lending capabilities with the hiring of a mortgage banking team of professionals and executives in the Phoenix, Arizona market. Operating under the brand, National Residential Mortgage, the unit had previously operated as a profitable division of a recently-failed thrift. The unit now provides residential mortgage lending services at all Bank Subsidiaries and serves the non-Heartland markets of metro San Diego, California; Austin, Texas; Reno, Nevada; and Buffalo, Wyoming. Administrative and back office support for these operations is performed by "Heartland Mortgage," a division of our lead bank, Dubuque Bank and Trust Company.

## **Consumer Lending**

The consumer lending departments of our Bank Subsidiaries provide a broad array of consumer loans, including 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.

Our consumer finance subsidiary, Citizens Finance Co., specializes in consumer lending and currently serves the consumer credit needs of nearly 10,000 customers from ten locations in Iowa, Illinois and Wisconsin. Citizens Finance Co. typically lends to borrowers with past credit problems or limited credit histories. Heartland expects to incur a higher level of credit losses on Citizens Finance Co. loans compared to consumer loans originated by the Bank Subsidiaries. Correspondingly, returns on these loans are anticipated to be higher than those at the Bank Subsidiaries.

## **Trust and Investment Services**

Dubuque Bank and Trust Company, Galena State Bank & Trust Co., Riverside Community Bank, Wisconsin Community Bank, New Mexico Bank & Trust, Arizona Bank & Trust and Minnesota Bank & Trust offer trust and investment services in their respective communities. In those markets that do not yet warrant a full trust department, the sales and administration is performed by Dubuque Bank and Trust Company personnel. As of December 31, 2011, total Heartland trust assets were \$2.2 billion, \$1.4 billion of which were assets under management. Collectively, the Bank Subsidiaries provide a full complement of trust and investment services for individuals and corporations.

Dubuque Bank and Trust Company is nationally recognized as a provider of socially responsible investment services, and it manages investment portfolios for religious and other non-profit organizations located throughout the United States. Dubuque Bank and Trust Company is also Heartland's lead bank in providing daily valuation 401(k) plans and other retirement services, including Heartland's retirement plan for its employees.

Heartland has formed a strategic alliance with LPL Financial Institution Services, a division of LPL Financial, to operate independent securities offices at all of the Bank Subsidiaries. Through LPL Financial, Heartland offers a full array of investment services including mutual funds, annuities, retirement products, education savings products, brokerage services, employer sponsored plans and insurance products. A complete line of vehicle, property and casualty, life and disability insurance is also offered by Heartland through DB&T Insurance.

## **B. MARKET AREAS**

### ***Dubuque Bank and Trust Company***

Dubuque Bank and Trust Company is primarily located in Dubuque County, Iowa, which encompasses the city of Dubuque and a number of surrounding rural communities. The city of Dubuque is located in northeastern Iowa, on the Mississippi River, approximately 175 miles west of Chicago, Illinois, and approximately 200 miles northeast of Des Moines, Iowa. It is strategically situated at the intersection of the state borders of Iowa, Illinois and Wisconsin. Based upon the results of the 2010 census, the city of Dubuque had a total population of 57,637 and Dubuque County had a total population of 93,653.

The principal office of Heartland and Dubuque Bank and Trust Company's main office currently occupy the same building. Heartland's operations center is located directly across the street from Dubuque Bank and Trust Company's main office. In addition to its main banking office, Dubuque Bank and Trust Company operates seven branch offices in Dubuque County, two branch offices in Keokuk, Iowa and one branch office in Carthage, Illinois. In June 2011, Heartland combined its First Community Bank charter with its Dubuque Bank and Trust Company charter. The consolidation of charters was designed to realize efficiencies in operating costs, audits, regulatory examinations and insurance premiums. The First Community Bank offices serve customers in the tri-county region of Lee County, Iowa; Hancock County, Illinois; and Clark County, Missouri. According to the 2010 census, the population of Keokuk, primarily an industrial community, is 10,780 and the population of Lee County is 35,862.

As a subsidiary of Dubuque Bank and Trust Company, DB&T Insurance has substantially the same market area as the parent organization.

The administrative and back office support for National Residential Mortgage, the brand name used for residential mortgage lending services at our Bank Subsidiaries, operates as a division of Dubuque Bank and Trust Company from an office facility in

Phoenix, Arizona. During 2011, Dubuque Bank and Trust Company opened residential mortgage loan production offices in metro San Diego, California; Austin, Texas; and Reno, Nevada.

### ***Galena State Bank & Trust Co.***

Galena State Bank & Trust Co.'s main office is in Galena, Illinois, approximately 20 miles east of Dubuque and 155 miles west of Chicago. Galena State Bank & Trust Co. also operates a second office in Galena, Illinois, an office in Stockton, Illinois, and an office in Elizabeth, Illinois. The four offices are located in Jo Daviess County, which has a population of 22,678, according to the 2010 census.

### ***Riverside Community Bank***

Riverside Community Bank is located on the northeast edge of Rockford, Illinois, which is approximately 75 miles west of Chicago in Winnebago County. In addition to its main banking office, Riverside Community Bank has three branch offices, all of which are located in the Winnebago County area. Based on the 2010 census, the county had a population of 295,266, and the city of Rockford had a population of 152,871.

### ***Wisconsin Community Bank***

Wisconsin Community Bank's main office is located in Madison, Wisconsin, in Dane County. The bank operates three branch offices in the Madison suburbs as well as one branch office in Monroe, Illinois. Based on the 2010 census, the Madison Metropolitan Statistical Area has a population of 568,593 and the population of the City of Madison is 233,209. The city of Monroe is approximately 50 miles southwest of Madison in Green County. Wisconsin Community Bank also has an office in the cities of Sheboygan and De Pere, Wisconsin, which operate under the name of Heartland Business Bank. Sheboygan and De Pere are located in the northeastern Wisconsin counties of Sheboygan and Brown, respectively.

### ***New Mexico Bank & Trust***

New Mexico Bank & Trust operates ten offices in or around Albuquerque, New Mexico, four offices in and around Clovis, New Mexico, and two offices in Santa Fe, New Mexico. Located in Bernalillo County, the Albuquerque Metropolitan Statistical Area has a 2010 population of 907,775 and the City of Albuquerque has a 2010 population of 545,852. Clovis, the county seat for Curry County, is located approximately 220 miles east of Albuquerque, 100 miles northwest of Lubbock, Texas, and 105 miles southwest of Amarillo, Texas, and has a population of 37,775. Santa Fe, located in Santa Fe County, has a population of 67,947.

### ***Arizona Bank & Trust***

Arizona Bank & Trust currently operates six offices in Arizona, including the main office in Phoenix, one in Mesa, one in Tempe, one in Gilbert and two in Chandler. These cities are all located in the Phoenix metropolitan area within Maricopa County. Based on the 2010 Census, Phoenix metro area is the 14th largest metro area by population in the United States with approximately 4.2 million people.

### ***Rocky Mountain Bank***

Rocky Mountain Bank operates from nine locations throughout the State of Montana. Rocky Mountain Bank's main office and a second office operate in Billings, which is the state's largest city and an agricultural, retail and business center. Billings is also the county seat of Yellowstone County, which has a 2010 Census population of 147,972 and the city has a population of 104,170. The bank has one office in northeastern Montana in the city of Plentywood. Its remaining six offices are spread throughout the western corridor of Montana in the cities of Bozeman, Bigfork, Kalispell, Plains, Stevensville and Whitehall. Rocky Mountain Bank recently opened a residential mortgage loan production office in Buffalo, Wyoming and is scheduled to open a second such office in Boise, Idaho in March 2012.

### ***Summit Bank & Trust***

The main facility for Summit Bank & Trust is in Broomfield, Colorado. The city and county of Broomfield are located in the northwestern tier of the Denver-Aurora Metropolitan Area. The population of Broomfield, according to the 2010 Census, is 55,889. Broomfield is the sixteenth most populous city in the State of Colorado. A second location was opened in June 2007 in Thornton, just west of the Denver International Airport and a third location was added in October of 2007 in the town of Erie, Colorado, which is approximately 25 miles north of Denver.



### ***Minnesota Bank & Trust***

Minnesota Bank & Trust currently operates from a leased facility in Edina, Minnesota, a first tier suburb of Minneapolis. The population of Edina was 47,941 in 2010 according to the U.S. Census Bureau.

### ***Citizens Finance Co.***

Citizens Finance Co. is headquartered in Dubuque, Iowa, with additional offices in Davenport and Cedar Rapids, Iowa; Madison and Appleton, Wisconsin; and the Illinois cities of Loves Park, Tinley Park, Crystal Lake, Aurora and Peoria.

The following table sets forth certain information concerning the Bank Subsidiaries as of December 31, 2011:

#### **Heartland Bank Subsidiaries (Dollars in thousands)**

| <b>Bank Subsidiaries</b>       | <b>Charter Location</b> | <b>Year Acquired or Opened</b> | <b>Number Of Bank Offices</b> | <b>Total Portfolio Loans</b> | <b>Total Deposits</b> |
|--------------------------------|-------------------------|--------------------------------|-------------------------------|------------------------------|-----------------------|
| Dubuque Bank and Trust Company | Dubuque, IA             | 1935                           | 11                            | \$ 778,467                   | \$ 938,000            |
| Galena State Bank & Trust Co.  | Galena, IL              | 1992                           | 4                             | \$ 157,398                   | \$ 243,639            |
| Riverside Community Bank       | Rockford, IL            | 1995                           | 4                             | \$ 155,320                   | \$ 264,699            |
| Wisconsin Community Bank       | Madison, WI             | 1997                           | 7                             | \$ 333,112                   | \$ 429,062            |
| New Mexico Bank & Trust        | Albuquerque, NM         | 1998                           | 16                            | \$ 508,874                   | \$ 690,293            |
| Arizona Bank & Trust           | Phoenix, AZ             | 2003                           | 6                             | \$ 146,346                   | \$ 177,457            |
| Rocky Mountain Bank            | Billings, MT            | 2004                           | 9                             | \$ 256,704                   | \$ 365,373            |
| Summit Bank & Trust            | Broomfield, CO          | 2006                           | 3                             | \$ 62,422                    | \$ 81,224             |
| Minnesota Bank & Trust         | Edina, MN               | 2008                           | 1                             | \$ 58,058                    | \$ 66,875             |

### **C. COMPETITION**

We encounter competition in all areas of our business. To compete effectively, develop our market base, maintain flexibility, and keep pace with changing economic and social conditions, we continuously refine and develop our products and services. The principal methods of competing in the financial services industry are through product selection, personal service and convenience.

The market areas of our Bank Subsidiaries are highly competitive. Many financial institutions based in the communities surrounding the Bank Subsidiaries actively compete for customers within our market area. We also face competition from finance companies, insurance companies, mortgage companies, securities brokerage firms, money market funds, loan production offices and other providers of financial services. Under the Gramm-Leach-Bliley Act, effective in 2000, securities firms and insurance companies that elect to become financial holding companies may acquire banks and other financial institutions. The Gramm-Leach-Bliley Act significantly changed, and we anticipate the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") will further change when fully implemented, the competitive environment in which we operate. The financial services industry is also likely to become more competitive as technological advances enable more companies to provide financial services. These technological advances may diminish the importance of depository institutions and other financial intermediaries in the transfer of funds between parties.

We compete for loans principally through the range and quality of the services we provide, with an emphasis on building long-lasting relationships. Our strategy is to serve our customers above and beyond their expectations through excellence in customer service and needs-based selling. We believe that our long-standing presence in the communities we serve and the personal service we emphasize enhance our ability to compete favorably in attracting and retaining individual and business customers. We actively solicit deposit-oriented clients and compete for deposits by offering personal attention, combined with online banking convenience, professional service and competitive interest rates.

## **D. EMPLOYEES**

At December 31, 2011, Heartland employed 1,195 full-time equivalent employees. We place a high priority on staff development, which involves extensive training in a variety of areas, including customer service training. New employees are selected based upon their technical skills and customer service capabilities. None of our employees are covered by a collective bargaining agreement. We offer a variety of employee benefits, and we consider our employee relations to be excellent. Predictive Index software is utilized to assist with placing potential employees in new positions and with evaluating current positions.

## **E. INTERNET ACCESS**

Heartland maintains an Internet site at [www.htlf.com](http://www.htlf.com). We offer our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and other reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") free of charge from our Web site.

## **F. SUPERVISION AND REGULATION**

### **General**

Financial institutions, their holding companies and their affiliates are extensively regulated under federal and state law. As a result, the growth and earnings performance of Heartland may be affected not only by management decisions and general economic conditions, but also by the requirements of federal and state statutes and by the regulations and policies of various bank regulatory authorities.

As a bank holding company with subsidiary banks chartered under the laws of eight different states, Heartland is regulated by the Board of Governors of the Federal Reserve System (the "Federal Reserve"). Each of the Bank Subsidiaries is regulated by the FDIC as its principal federal regulator and one of the following as its state regulator: the Arizona State Banking Department (the "Arizona Department"), the Colorado Department of Regulatory Agencies, Division of Banking (the "Colorado Division"), the Illinois Department of Financial and Professional Regulation (the "Illinois DFPR"), the Iowa Superintendent of Banking (the "Iowa Superintendent"), the Minnesota Department of Commerce: Division of Financial Institutions (the "Minnesota Division"), the Montana Division of Banking and Financial Institutions (the "Montana Division"), the New Mexico Financial Institutions Division (the "New Mexico FID"), the Division of Banking of the Wisconsin Department of Financial Institutions (the "Wisconsin DFI").

As a recipient of Capital Purchase Program (the "CPP") funds under the Troubled Asset Relief Program (the "TARP") established by the Emergency Economic Stabilization Act of 2008 (the "EESA") until September 15, 2011, and a participant in the Small Business Lending Fund (the "SBLF") established by the Small Business Jobs Act of 2010, Heartland is also subject to direct supervision by the United States Department of the Treasury (the "U.S. Treasury").

Taxation laws administered by the Internal Revenue Service and state taxing authorities and securities laws administered by the Securities and Exchange Commission (the "SEC") and state securities authorities also have an impact on the business of Heartland. The effect of these statutes, regulations and regulatory policies may be significant, and cannot be predicted with a high degree of certainty.

Federal and state laws and regulations generally applicable to financial institutions regulate, among other things, the scope of business, the kinds and amounts of investments, reserve requirements, capital levels, the establishment of branches, mergers and consolidations and the payment of dividends. This system of supervision and regulation establishes a comprehensive framework for the respective operations of Heartland and its subsidiaries and is intended primarily for the protection of the FDIC-insured deposits and depositors of the Bank Subsidiaries, rather than stockholders.

The following is a summary of material elements of the regulatory framework that applies to Heartland and its subsidiaries. It does not describe all of the statutes, regulations and regulatory policies that apply, nor does it restate all of the requirements of those that are described. As such, the following is qualified in its entirety by reference to applicable law. Each of the federal agencies that regulate Heartland and its Bank Subsidiaries is required to adopt regulations under the Dodd-Frank Act. Any such change in regulations or regulatory policies, or further change in applicable law, may have a material effect on the business of Heartland and its subsidiaries.

## **Dodd-Frank Act**

The Dodd-Frank Act, which was enacted into law on July 21, 2010, significantly changed the regulatory framework for banks and bank holding companies, and required significant rulemaking and numerous studies and reports. Among other things, the Dodd-Frank Act:

- established the Bureau of Consumer Financial Protection (the "BCFP"), with broad authority to regulate providers of credit, savings, payment and other consumer financial products and services;
- significantly reduced interchange fees on debit card transactions;
- made permanent the \$250,000 deposit insurance limit on insured deposits, and revised the assessment base for the calculation of the FDIC insurance assessments for financial institutions;
- requires federal banking agencies to adopt regulations relating to compensation practices of covered institutions; and
- requires risk retention on mortgage originations.

Regulations implementing many of the above requirements have been finalized or proposed, and additional regulations or guidelines from the BCFP are expected to significantly change the format of many consumer offerings. The Dodd-Frank Act also requires more far-reaching changes in the regulation of banks and bank holding companies by:

- restricting securities trading activities and support for and investments in private funds;
- creating a new structure for anticipating and resolving troubled or failed financial institutions with enhanced prudential standards, early remediation of financial distress, and enhanced liquidity requirements; and
- requiring the federal banking agencies to adopt new capital requirements.

Most of the regulations implementing, or proposing changes to implement, these requirements are designed to apply to larger institutions: primarily institutions or holding companies with more than \$50 billion of assets. In 2011, the Federal Reserve issued a final rule requiring the filing of annual capital plans by banks and bank holding companies with more than \$50 billion in assets, that demonstrate projected compliance with capital requirements. In December 2011, the Federal Reserve issued a proposed rule relating to enhanced prudential standards for bank holding companies with over \$50 billion in consolidated assets that would include enhanced risk-based capital and leverage requirements, enhanced liquidity requirements, enhanced risk management and risk committee requirements, a requirement to submit a resolution plan, single-counterparty credit limits and stress tests. Further, in June 2011 the Basel Committee on Banking Supervision agreed to revised bank capital adequacy, stress testing and market liquidity risk standards ("Basel III"). In December 2011, the Federal Reserve indicated that it intended to implement substantially all of the Basel III rules for banks with more than \$50 billion in assets and would issue proposed regulations to do so in early 2012. Although none of these regulations would initially apply to Heartland, the financial regulatory agencies often expand application once they have experience with a regulatory regime.

In addition to the Dodd-Frank Act, other legislative proposals have been made both domestically and internationally. Among other things, these proposals include additional capital and liquidity requirements and limitations on size or types of activity in which banks may engage.

## **Heartland**

### ***General***

Heartland, as the sole shareholder of Dubuque Bank and Trust Company, New Mexico Bank & Trust, Rocky Mountain Bank, Wisconsin Community Bank, Galena State Bank & Trust Co., Riverside Community Bank, Arizona Bank & Trust and Summit Bank & Trust, and the controlling shareholder of Minnesota Bank & Trust, is a bank holding company. As a bank holding company, Heartland is registered with, and is subject to regulation by, the Federal Reserve under the BHCA. In accordance with Federal Reserve policy, Heartland is expected to act as a source of financial strength to the Bank Subsidiaries and to commit resources to support the Bank Subsidiaries in circumstances where Heartland might not otherwise do so. In addition, under the Dodd-Frank Act, the FDIC has backup enforcement authority over a depository institution holding company, such as Heartland, if the conduct or threatened conduct of the holding company poses a risk to the Deposit Insurance Fund, although such authority may not be used if the holding company is in sound condition and does not pose a foreseeable and material risk to the insurance fund.

Under the BHCA, Heartland is subject to periodic examination by the Federal Reserve. Heartland is also required to file with the Federal Reserve periodic reports of Heartland's operations and such additional information regarding Heartland and its subsidiaries as the Federal Reserve may require.

### ***Acquisitions, Activities and Change in Control***

The primary purpose of a bank holding company is to control and manage banks. The BHCA generally requires the prior approval of the Federal Reserve for any merger involving a bank holding company or any acquisition by a bank holding company. Subject to certain conditions (including certain deposit concentration limits established by the BHCA), the Federal Reserve may allow a bank holding company to acquire banks located in any State of the United States. In approving interstate acquisitions, the Federal Reserve is required to give effect to applicable state law limitations on the aggregate amount of deposits that may be held by the acquiring bank holding company and its insured depository institution affiliates in the state in which the target bank is located (provided that those limits do not discriminate against out-of-state depository institutions or their holding companies).

The BHCA generally prohibits Heartland from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company that is not a bank and from engaging in any business other than that of banking, managing and controlling banks, or furnishing services to banks and their subsidiaries. This general prohibition is subject to a number of exceptions. The principal exception allows bank holding companies to engage in, and to own shares of companies engaged in, certain businesses found by the Federal Reserve to be “so closely related to banking ... as to be a proper incident thereto.” This authority would permit Heartland to engage in a variety of banking-related businesses, including consumer finance, equipment leasing, mortgage banking, brokerage, and the operation of a computer service bureau (including software development). Under the Dodd-Frank Act, however, any such non-bank subsidiary would be subject to regulation no less stringent than that applicable to the lead bank of the bank holding company. The BHCA generally does not place territorial restrictions on the domestic activities of non-bank subsidiaries of bank holding companies.

Additionally, bank holding companies that meet certain eligibility requirements prescribed by the BHCA and elect to operate as financial holding companies may engage in, or own shares in companies engaged in, a wider range of nonbanking activities, including securities and insurance underwriting and sales, merchant banking and any other activity that the Federal Reserve, in consultation with the Secretary of the Treasury, determines by regulation or order is financial in nature, incidental to any such financial activity or complementary to any such financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally. As of the date of this filing, Heartland has not applied for approval to operate as a financial holding company.

Federal law also prohibits any person or persons acting in concert from acquiring “control” of an FDIC-insured depository institution or its holding company without prior notice to the appropriate federal bank regulator or any other company acquiring “control” without Federal Reserve approval to become a bank holding company. “Control” is conclusively presumed to exist upon the acquisition of 25% or more of the outstanding voting securities of a bank or bank holding company, but may arise at 10% ownership for companies with registered securities, such as Heartland, and under certain other circumstances. Each of the Bank Subsidiaries is generally subject to similar restrictions on changes in control under the law of the state granting its charter.

### ***Capital Requirements***

Bank holding companies are required to maintain minimum levels of capital in accordance with Federal Reserve capital adequacy guidelines, separate from and in addition to the capital requirements applicable to subsidiary financial institutions. If a bank holding company is not well-capitalized, under the Dodd-Frank Act it will have difficulty engaging in acquisition transactions and if its capital levels fall below the minimum required levels, a bank holding company, among other things, may be denied approval to acquire or establish additional banks or non-bank businesses.

The Federal Reserve's capital guidelines applicable to bank holding companies, like the regulations applicable to subsidiary banks, require holding companies to comply with both (i) a risk-based requirement expressed as a percentage of total assets weighted according to risk; and (ii) a leverage requirement expressed as a percentage of total assets. Although the amount of capital required for holding companies is generally the same as required for subsidiary banks as described under “The Bank Subsidiaries-Capital Requirements” below, historically the form of capital has differed for holding companies and allowed the inclusion of certain hybrid instruments, such as trust preferred, in Tier 1 capital. Under the Dodd-Frank Act, these distinctions were eliminated for instruments issued after May 19, 2010. Although the distinctions are also phased out for trust preferred issued by larger institutions prior to that date, the trust preferred issued by Heartland, as a holding company with less than \$15 billion in assets, are grandfathered as Tier 1 capital by the Dodd-Frank Act.

As of December 31, 2011, Heartland had regulatory capital in excess of the Federal Reserve's minimum requirements.

***Treasury Regulation-the Emergency Economic Stabilization Act of 2008, the American Recovery and Reinvestment Tax Act of 2009 and the Small Business Jobs Act of 2010***

Bank holding companies that receive funding under the TARP CPP or the SBLF are subject to direct regulation by the U.S. Treasury. The TARP CPP under EESA was created by the U.S. Treasury in 2008 to invest in the senior preferred stock of qualifying U.S. banks and savings associations or their holding companies. Under the CPP, qualifying financial institutions issued to the U.S. Treasury senior preferred stock that was non-voting, carried dividends and could be included as capital, as well as warrants to purchase common stock based upon the amount of senior preferred stock the U.S. Treasury acquired.

On December 19, 2008, Heartland issued and sold to the U.S. Treasury pursuant to the CPP \$81.7 million of its senior preferred stock together with a 10-year warrant to purchase 609,687 shares of Heartland's common stock at \$20.10 per share. The senior preferred stock qualified as Tier 1 capital under the Federal Reserve's capital guidelines and provided Heartland with considerable regulatory flexibility during 2009 and 2010. Consistent with terms that were set by the U.S. Treasury uniformly among all publicly held banks participating in the program, the senior preferred stock required the payment of dividends to the U.S. Treasury at a rate of 5% per year, increasing to 9% after the fifth year. The senior preferred stock, the agreements under which it and the warrant were issued, and regulations issued under EESA and the American Recovery and Reinvestment Act of 2009, contained a number of restrictions on the payment by Heartland of dividends and on compensation paid to executive officers and highly paid employees while Heartland participated in the CPP.

In an effort to encourage more small business lending by community banks, and as mandated by the Small Business Jobs Act of 2010, in early 2011 the U.S. Treasury started making available up to \$30.0 billion of capital under the SBLF to qualifying banks with less than \$10.0 billion of assets. Under the SBLF, the U.S. Treasury purchased from qualifying financial institutions senior perpetual non-cumulative preferred stock with a liquidation preference of \$1,000 per share. Like the preferred stock issued under TARP, the preferred stock issued under the SBLF is non-voting (except in limited circumstances) and qualifies as Tier 1 capital under the Federal Reserve's guidelines.

SBLF funding was made available to participants in the TARP CPP as a method to refinance the senior preferred stock issued under the CPP, and Heartland applied for SBLF Funding in March 2011. Heartland's application was accepted in August, and on September 15, 2011, Heartland issued 81,698 shares of its Senior Non-Cumulative Perpetual Preferred Stock, Series C (the "Series C Preferred Stock"), to the U.S. Treasury under the SBLF, and simultaneously used the \$81.7 million received under the SBLF to redeem the 81,698 shares of senior preferred stock it had issued under the TARP CPP program. As part of this transaction, Heartland recorded a charge of \$2.6 million representing the unamortized discount on the TARP senior preferred stock that was redeemed. Further, on September 28, 2011, Heartland repurchased the warrant to purchase 609,687 shares of its common stock that it issued to the U.S. Treasury under the TARP CPP program for \$1.8 million.

The Series C Preferred Stock issued under the SBLF requires quarterly dividends payable to the U.S. Treasury initially equal to 5.00% of the liquidation value of the Preferred Stock. The dividend rate payable under the Series C Preferred Stock is subject to reduction during the second to tenth quarters after issuance (through December 31, 2013, for Heartland) based upon increases in Heartland's qualified small business lending ("QSBL") over a baseline amount, and may be reduced to as low as 1.00% if QSBL increases by ten percent or more over that period. If Heartland's QSBL does not increase by the tenth quarter, the rate will increase to 7.00%. In addition, if there is no increase in Heartland's small business lending by January 1, 2014, (the fifth annual anniversary of receipt of CPP funds) Heartland will be required to pay a special lending incentive fee of 2.00% per year (a total rate of 9.00%) through March 31, 2016. From the eleventh quarter through March 16, 2016, the rate remains fixed at the rate determined at the end of the tenth quarter and will increase to 9.00% if the SBLF funding has not been repaid by March 16, 2016.

Although Heartland is no longer subject to the significant restrictions imposed under the TARP CPP program, it does have ongoing quarterly reporting obligations to the U.S. Treasury under the SBLF that will be used by the U.S. Treasury to determine the dividend rate. The terms of the Series C Preferred Stock also prohibit Heartland from paying dividends on its common stock, or repurchasing shares, to the extent that, after payment of such dividends or repurchases, Heartland's Tier 1 Capital would be less than the difference between (i) 90% of its Tier 1 Capital on September 15, 2011 (\$281.2 million), and (ii) net charge-offs and any redemptions of the Series C Preferred Stock. This limitation is reduced by 10% for each one percent increase in Heartland's QSBL over the baseline level. If, however Heartland fails to declare and pay dividends on the Series C Preferred Stock in a given quarter, then Heartland may not pay dividends on or repurchase any common stock for the next three quarters, except in very limited circumstances. If any Series C Preferred Stock remains outstanding on the tenth anniversary of issuance, Heartland may not pay any further dividends on its common stock or any other junior stock until the Series C Preferred Stock is redeemed in full.

### ***Dividend Payments***

In addition to the restrictions imposed under the SBLF, Heartland's ability to pay dividends to its stockholders may be affected by both general corporate law considerations, and policies of the Federal Reserve applicable to bank holding companies. As a Delaware corporation, Heartland is subject to the limitations of the Delaware General Corporation Law (the "DGCL"), which allows Heartland to pay dividends only out of its surplus (as defined and computed in accordance with the provisions of the DGCL) or if Heartland has no such surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year. In addition, policies of the Federal Reserve caution that a bank holding company should not pay cash dividends unless its net income available to common stockholders over the past year has been sufficient to fully fund the dividends and the prospective rate of earnings retention appears consistent with its capital needs, asset quality, and overall financial condition. The Federal Reserve also possesses enforcement powers over bank holding companies and their non-bank subsidiaries to prevent or remedy actions that represent unsafe or unsound practices or violations of applicable statutes and regulations. Among these powers is the ability to proscribe the payment of dividends by banks and bank holding companies.

### ***Federal Securities Regulation***

Heartland's common stock is registered with the SEC under Section 12(b) of the Exchange Act. Consequently, Heartland is subject to the information, proxy solicitation, insider trading and other restrictions and requirements of the SEC under the Exchange Act.

### ***The Bank Subsidiaries***

#### ***General***

All of the Bank Subsidiaries are state chartered, non-member banks, which means that they are all formed under state law and are not members of the Federal Reserve System. As such, each bank is subject to direct regulation by the banking authorities in the State in which it was chartered, as well as by the FDIC as its primary federal regulator.

Dubuque Bank and Trust Company is an Iowa-chartered bank. As an Iowa-chartered bank, Dubuque Bank and Trust Company is subject to the examination, supervision, reporting and enforcement requirements of the Iowa Superintendent, the chartering authority for Iowa banks.

Galena State Bank & Trust Co. and Riverside Community Bank are Illinois-chartered banks. As Illinois-chartered banks, Galena State Bank & Trust Co. and Riverside Community Bank are subject to the examination, supervision, reporting and enforcement requirements of the Illinois DFPR, the chartering authority for Illinois banks.

New Mexico Bank & Trust is a New Mexico-chartered bank. As a New Mexico-chartered bank, New Mexico Bank & Trust is subject to the examination, supervision, reporting and enforcement requirements of the New Mexico FID, the chartering authority for New Mexico banks.

Rocky Mountain Bank is a Montana-chartered bank. As a Montana-chartered bank, Rocky Mountain Bank is subject to the examination, supervision, reporting and enforcement requirements of the Montana Division, the chartering authority for Montana banks.

Wisconsin Community Bank is a Wisconsin-chartered bank. As a Wisconsin-chartered bank, Wisconsin Community Bank is subject to the examination, supervision, reporting and enforcement requirements of the Wisconsin DFI, the chartering authority for Wisconsin banks.

Summit Bank & Trust is a Colorado-chartered bank. As a Colorado-chartered bank, Summit Bank & Trust is subject to the examination, supervision, reporting and enforcement requirements of the Colorado Division, the chartering authority for Colorado banks.

Arizona Bank & Trust is an Arizona-chartered bank. As an Arizona-chartered bank, Arizona Bank & Trust is subject to the examination, supervision, reporting and enforcement requirements of the Arizona Department, the chartering authority for Arizona banks.

Minnesota Bank & Trust is a Minnesota-chartered bank. As a Minnesota-chartered bank, Minnesota Bank & Trust is subject to the examination, supervision, reporting and enforcement requirements of the Minnesota Division, the chartering authority for Minnesota banks.



### ***Deposit Insurance***

The FDIC is an independent federal agency that insures the deposits, up to \$250,000, of federally insured banks and savings institutions and safeguards the safety and soundness of the commercial banking and thrift industries.

As FDIC-insured institutions, the Bank Subsidiaries are required to pay deposit insurance premium assessments to the FDIC based upon a risk-based assessment system. Under this system, each institution is assigned a risk classification based upon its capital levels and the level of supervisory concern it poses. The rate of insurance premium the institution pays was based on this risk classification and the amount of its deposits until April 1, 2011. Currently, FDIC insurance assessments are based upon average total consolidated assets minus tangible equity of the insured bank.

The aggregate level of assessments levied by the FDIC on depository institutions is dependent upon the reserve ratio of insurance funds available to the FDIC. Due to bank failures during 2008, the reserve ratio fell below the statutory minimum and the FDIC adopted a plan to restore the ratio to its 1.15% minimum. On February 27, 2009, the FDIC announced that it was increasing the quarterly deposit insurance assessment for most insured institutions to a range of 12 to 16 basis points (0.12% to 0.16%) per quarter for the second quarter of 2009. The FDIC also imposed a special emergency assessment of an additional 5 basis points on each FDIC-insured depository institution's assets, minus its Tier 1 capital, as of June 30, 2009, which was due and paid by Heartland on September 30, 2009. On November 12, 2009, the FDIC adopted a final rule requiring prepayment of 13 quarters of each institution's estimated FDIC premiums for the fourth quarter of 2009 and all of 2010, 2011 and 2012. Heartland prepaid the required \$19.0 million in December 2009 and had a \$9.5 million remaining prepaid balance on December 31, 2011. The expense related to this prepayment is expected to be recognized during 2012 based on the calculation of actual quarterly assessments.

The Dodd-Frank Act directed that the minimum deposit insurance fund reserve ratio would increase from 1.15% to 1.35% by September 30, 2020, and the cost of the increase will be borne by depository institutions with assets of \$10 billion or more. The Dodd-Frank Act also provides the FDIC with discretion to determine whether to pay rebates to insured depository institutions when its deposit insurance reserves exceed certain thresholds. Previously, the FDIC was required to give rebates to depository institutions equal to the excess once the reserve ratio exceeded 1.50%, and was required to rebate 50% of the excess over 1.35% but not more than 1.50% of insured deposits. The FDIC adopted a final rule on February 7, 2011, that implements these provisions of the Dodd-Frank Act.

The FDIC established a Temporary Liquidity Guarantee Program on October 23, 2008, under which the FDIC fully guaranteed all non-interest-bearing transaction accounts and all senior unsecured debt of insured depository institutions or their qualified holding companies issued between October 14, 2008, and October 31, 2009. Heartland did not opt out of the program and as such, was assessed ten basis points during the first quarter of 2010 and fifteen basis points for the remainder of 2010 for transaction account balances in excess of \$250,000 and, since it did not issue any senior unsecured debt during the designated time period, was not assessed the applicable rate of 75 basis points on the amount of debt issued. The guarantee of non-interest-bearing transaction accounts was twice extended by the FDIC, and under the Dodd-Frank Act was extended to December 31, 2012, and made applicable to all institutions, without further assessment. The total assessments paid by Heartland during 2010 and 2011 for participation in the Temporary Liquidity Guarantee Program totaled \$235,000 and \$84,000, respectively.

In addition, all institutions with deposits insured by the FDIC are required to pay assessments to fund interest payments on bonds issued by the Financing Corporation, an agency of the Federal government established to recapitalize the predecessor to the Savings Association Insurance Fund. During 2011, the assessment rate was 0.0102% of insured deposits. These assessments will continue until the Financing Corporation bonds mature in 2019.

### ***Supervisory Assessments***

Each of the Bank Subsidiaries is required to pay supervisory assessments to its respective state banking regulator to fund the operations of that agency. In general, the amount of the assessment is calculated on the basis of each institution's total assets. During 2011, the Bank Subsidiaries paid supervisory assessments totaling \$554,000.

### ***Capital Requirements***

Under federal regulations, the Bank Subsidiaries are subject to the following minimum capital standards: (i) a leverage requirement consisting of a minimum ratio of Tier 1 capital to total assets of 3% for the most highly-rated banks with a minimum requirement of at least 4% for all others; and (ii) a risk-based capital requirement consisting of a minimum ratio of total capital to total risk-weighted assets of 8% and a minimum ratio of Tier 1 capital to total risk-weighted assets of 4%. For purposes of these capital standards, Tier 1 capital consists primarily of permanent stockholders' equity less intangible assets (other than certain loan servicing rights and purchased credit card relationships). Total capital consists primarily of Tier 1 capital plus certain other debt and equity instruments that do not qualify as Tier 1 capital and, for Heartland, a portion of its allowance for loan and lease losses.

The capital requirements described above are minimum requirements. Higher capital levels will be required if warranted by the particular circumstances or risk profiles of individual institutions. For example, federal regulations provide that additional capital may be required to take adequate account of, among other things, interest rate risk or the risks posed by concentrations of credit, nontraditional activities or securities trading activities. As a *de novo* bank, Minnesota Bank & Trust is required to maintain higher Tier 1 capital to assets ratios for the first seven years of its operations (through April 2016). Further, under agreements with the FDIC and state banking agencies described below under “Safety and Soundness Standards,” Summit Bank & Trust is required to maintain a ratio of Tier 1 Capital to total assets of 8% and Arizona Bank & Trust and Rocky Mountain Bank are required to maintain both a ratio of Tier 1 capital to total assets of 8% and a ratio of total risk-based capital to risk-weighted assets of 12%.

Further, federal law and regulations provide various incentives for financial institutions to maintain regulatory capital at levels in excess of minimum regulatory requirements. For example, a financial institution generally must be “well-capitalized” to engage in acquisitions, and well-capitalized institutions may qualify for exemptions from prior notice or application requirements otherwise applicable to certain types of activities and may qualify for expedited processing of other required notices or applications. Additionally, one of the criteria that determines a bank holding company's eligibility to operate as a financial holding company is a requirement that both the holding company and all of its financial institution subsidiaries be “well-capitalized.” Under federal regulations, in order to be “well-capitalized” a financial institution must maintain a ratio of total capital to total risk-weighted assets of 10% or greater, a ratio of Tier 1 capital to total risk-weighted assets of 6% or greater and a ratio of Tier 1 capital to total assets of 5% or greater.

Federal law also provides the federal banking regulators with broad power to take prompt corrective action to resolve the problems of undercapitalized institutions. The extent of the regulators' powers depends on whether the institution in question is “adequately capitalized,” “undercapitalized,” “significantly undercapitalized” or “critically undercapitalized,” in each case as defined by regulation. Depending upon the capital category to which an institution is assigned, the regulators' corrective powers include: (i) requiring the institution to submit a capital restoration plan; (ii) limiting the institution's asset growth and restricting its activities; (iii) requiring the institution to issue additional capital stock (including additional voting stock) or to be acquired; (iv) restricting transactions between the institution and its affiliates; (v) restricting the interest rate the institution may pay on deposits; (vi) ordering a new election of directors of the institution; (vii) requiring that senior executive officers or directors be dismissed; (viii) prohibiting the institution from accepting deposits from correspondent banks; (ix) requiring the institution to divest certain subsidiaries; (x) prohibiting the payment of principal or interest on subordinated debt; and (xi) ultimately, appointing a receiver for the institution.

As of December 31, 2011: (i) none of the Bank Subsidiaries was subject to a directive from its primary federal regulator to increase its capital; (ii) each of the Bank Subsidiaries exceeded its minimum regulatory capital requirements under applicable capital adequacy guidelines; (iii) each of the Bank Subsidiaries was “well-capitalized,” as defined by applicable regulations; and (iv) each of the Bank Subsidiaries subject to a directive to maintain capital higher than the regulatory capital requirements, as discussed below under “Safety and Soundness Standards,” complied with the directive.

#### ***Liability of Commonly Controlled Institutions***

Under federal law, institutions insured by the FDIC may be liable for any loss incurred by, or reasonably expected to be incurred by, the FDIC in connection with the default of commonly controlled FDIC-insured depository institutions or any assistance provided by the FDIC to commonly controlled FDIC-insured depository institutions in danger of default. Because Heartland controls each of the Bank Subsidiaries, the Bank Subsidiaries are commonly controlled for purposes of these provisions of federal law.

#### ***Dividend Payments***

The primary source of funds for Heartland is dividends from the Bank Subsidiaries. In general, the Bank Subsidiaries may only pay dividends either out of their historical net income after any required transfers to surplus or reserves have been made or out of their retained earnings.

The payment of dividends by any financial institution is affected by the requirement to maintain adequate capital pursuant to applicable capital adequacy guidelines and regulations, and a financial institution generally is prohibited from paying any dividends if, following payment thereof, the institution would be undercapitalized. As described above, each of the Bank Subsidiaries exceeded its minimum capital requirements under applicable guidelines as of December 31, 2011. Minnesota Bank & Trust is subject to the FDIC's further prohibition on the payment of dividends during the first seven years of a bank's operations, allowing cash dividends to be paid only from net operating income, and prohibiting the payment of dividends until an appropriate allowance for loan and lease losses has been established and overall capital is adequate. Pursuant to agreements with the FDIC and the state banking agencies described below under “Safety and Soundness Standards,” Arizona Bank &

Trust, Summit Bank & Trust and Rocky Mountain Bank may not pay any dividends without prior notice to, and consent from, the FDIC and the state banking regulator.

As of December 31, 2011, approximately \$77.9 million was available to be paid as dividends by the Bank Subsidiaries. Notwithstanding the availability of funds for dividends, however, the FDIC may prohibit the payment of any dividends by the Bank Subsidiaries.

### ***Insider Transactions***

The Bank Subsidiaries are subject to certain restrictions imposed by federal law on extensions of credit to Heartland and its subsidiaries, on investments in the stock or other securities of Heartland and its subsidiaries and the acceptance of the stock or other securities of Heartland or its subsidiaries as collateral for loans made by the Bank Subsidiaries. Certain limitations and reporting requirements are also placed on extensions of credit by each of the Bank Subsidiaries to its directors and officers, to directors and officers of Heartland and its subsidiaries, to principal stockholders of Heartland and to “related interests” of such directors, officers and principal stockholders. In addition, federal law and regulations may affect the terms upon which any person who is a director or officer of Heartland or any of its subsidiaries or a principal stockholder of Heartland may obtain credit from banks with which the Bank Subsidiaries maintain correspondent relationships.

### ***Safety and Soundness Standards***

The federal banking agencies have adopted guidelines that establish operational and managerial standards to promote the safety and soundness of federally insured depository institutions. The guidelines set forth standards for internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, asset quality and earnings. In general, the safety and soundness guidelines prescribe the goals to be achieved in each area, and each institution is responsible for establishing its own procedures to achieve those goals. If an institution fails to comply with any of the standards set forth in the guidelines, the institution's primary federal regulator may require the institution to submit a plan for achieving and maintaining compliance. If an institution fails to submit an acceptable compliance plan, or fails in any material respect to implement a compliance plan that has been accepted by its primary federal regulator, the regulator is required to issue an order directing the institution to cure the deficiency. Until the deficiency cited in the regulator's order is cured, the regulator may restrict the institution's rate of growth, require the institution to increase its capital, restrict the rates the institution pays on deposits or require the institution to take any action the regulator deems appropriate under the circumstances. Noncompliance with the standards established by the safety and soundness guidelines may also constitute grounds for other enforcement action by the federal banking regulators, including cease and desist orders and civil money penalty assessments.

During their regular scheduled joint examinations of the Bank Subsidiaries, the FDIC and state banking commissioners cited four of the Bank Subsidiaries for certain deficiencies, including asset quality. In January of 2009, the boards of directors of Summit Bank & Trust and Arizona Bank & Trust, and in the fall of 2009, the board of directors of Rocky Mountain Bank, entered into informal agreements with the FDIC and their respective state banking commissioners, agreeing to submit plans for improvement in the risks associated with any classified asset with a balance of more than \$250,000, agreeing not to extend or renew credit to borrowers under loans that are classified, agreeing to review and ensure the sufficiency of the allowance for loan and lease losses and agreeing to submit a business plan outlining the plans to accomplish these measures as well as periodic progress reports against that plan. As noted above, these Bank Subsidiaries also agreed to maintain higher levels of regulatory capital and to refrain from paying dividends without regulatory approval. Each of these Bank Subsidiaries remains well capitalized and has complied with its agreement with its regulators. In November of 2011, the board of directors of Wisconsin Community Bank entered into an informal agreement with the FDIC and its state banking commissioner, agreeing to correct certain consumer compliance violations.

### ***Branching Authority***

Each of the Bank Subsidiaries has the authority, pursuant to the laws under which it is chartered, to establish branches anywhere in the state in which its main office is located, subject to the receipt of all required regulatory approvals.

Federal law permits state and national banks to merge with banks in other states subject to: (i) regulatory approval; (ii) federal and state deposit concentration limits; and (iii) state law limitations requiring the merging bank to have been in existence for a minimum period of time (not to exceed five years) prior to the merger. Under the Dodd-Frank Act, banks are permitted to establish new branches in another state to the same extent as banks chartered in the other state.

### ***State Bank Investments and Activities***

Each of the Bank Subsidiaries generally is permitted to make investments and engage in activities directly or through subsidiaries as authorized by the laws of the state under which it is chartered. However, under federal law and FDIC regulations, FDIC-insured state banks are prohibited, subject to certain exceptions, from making or retaining equity

investments of a type, or in an amount, that are not permissible for a national bank. Federal law and FDIC regulations also prohibit FDIC-insured state banks and their subsidiaries, subject to certain exceptions, from engaging as principal in any activity that is not permitted for a national bank unless the bank meets, and continues to meet, its minimum regulatory capital requirements and the FDIC determines the activity would not pose a significant risk to the deposit insurance fund of which the bank is a member.

The Dodd-Frank Act prohibits insured depository institutions and their holding companies from engaging in proprietary trading except in limited circumstances, and prohibits them from owning equity interests in excess of 3% of a bank's Tier 1 Capital in private equity and hedge funds. The Federal Reserve released a final rule on February 9, 2011, (effective on April 1, 2011) which requires a "banking entity," a term that is defined to include bank holding companies like Heartland, to bring its proprietary trading activities and investments into compliance with the Dodd-Frank Act restrictions no later than two years after the earlier of: (1) July 21, 2012, or (2) 12 months after the date on which interagency final rules are adopted. Pursuant to the compliance date final rule, banking entities are permitted to request an extension of this timeframe from the Federal Reserve.

These restrictions have not had, and are not currently expected to have, a material impact on the operations of the Bank Subsidiaries.

#### ***Federal Reserve Liquidity Regulations***

Federal Reserve regulations, as presently in effect, require depository institutions to maintain non-interest earning reserves against their transaction accounts (primarily NOW and regular checking accounts), as follows: (i) for transaction accounts aggregating \$10.7 million or less, there is no reserve requirement; (ii) for transaction accounts over \$10.7 million and up to \$55.2 million, the reserve requirement is 3% of total transaction accounts; and (iii) for transaction accounts aggregating in excess of \$55.2 million, the reserve requirement is \$1.335 million plus 10% of the aggregate amount of total transaction accounts in excess of \$55.2 million. These reserve requirements are subject to annual adjustment by the Federal Reserve. The Bank Subsidiaries are in compliance with the foregoing requirements.

### **G. GOVERNMENTAL MONETARY POLICY AND ECONOMIC CONDITIONS**

Heartland's earnings are affected by the policies of regulatory authorities, including the Federal Reserve. The Federal Reserve's monetary policies have significantly affected the operating results of commercial banks in the past and are expected to continue doing so in the future. Changing economic and money market conditions prompted by the actions of monetary and fiscal authorities may cause changes in interest rates, credit availability, and deposit levels that are beyond Heartland's control. Future policies of the Federal Reserve and other authorities cannot be predicted, nor can their effect on future earnings.

#### **ITEM 1A.**

#### **RISK FACTORS**

In addition to the other information in this Annual Report on Form 10-K, stockholders or prospective investors should carefully consider the following risk factors that may adversely affect our business, financial results or stock price. Additional risks that we currently do not know about or currently view as immaterial may also impair our business or adversely impact our financial results or stock price.

#### **Our business and financial results are significantly affected by general business and economic conditions.**

Our business activities and earnings are affected by general business conditions in the United States and particularly in the states in which our Bank Subsidiaries operate. Like most financial institutions, the 2008-2009 recession, and the declines in the housing market and real estate values, increased credit defaults, increased foreclosures, and write-downs of asset values, negatively impacted our business and results of operations. Although financial markets have stabilized, the global economies have improved and there has been some recovery in 2010 and 2011, certain segments of the economy continue to be depressed. Further, the economic outlook is clouded by the credit crisis in Europe, and consumer confidence has been periodically shaken by political gridlock, increased energy prices and other events. Further economic deterioration that affects household and/or corporate incomes could result in renewed credit deterioration and reduced demand for credit or fee-based products and services, negatively impacting our performance. In addition, changes in securities market conditions and monetary fluctuations could adversely affect the availability and terms of funding necessary to meet our liquidity needs.

**Recent legislation has impacted our operations, and additional legislation and rulemaking could impact us adversely.**

The recent recession spawned a number of significant new laws that impact financial institutions, including the EESA, ARRA and Dodd-Frank Act. The Dodd-Frank Act is particularly far reaching, establishing the BCFP with broad authority to administer and enforce a new federal regulatory framework of consumer financial regulation, changing the base for deposit insurance assessments, introducing regulatory rate-setting for interchange fees charged to merchants for debit card transactions, enhancing the regulation of consumer mortgage banking, changing the methods and standards for resolution of troubled institutions, and changing the Tier 1 regulatory capital ratio calculations for bank holding companies. The liquidity, capital and stress testing requirements of Basel III in particular, if applied to mid-sized institutions such as Heartland, could negatively impact our operations. Many of the provisions of the Dodd-Frank Act have extended implementation periods and delayed effective dates and will require additional rulemaking by various regulatory agencies, and many could have far reaching implications on our operations. Accordingly, Heartland cannot currently quantify the ultimate impact of this legislation and the related future rulemaking, but expects that the legislation may have a detrimental impact on revenues and expenses, require Heartland to change certain of its business practices, increase Heartland's capital requirements and otherwise adversely affect its business.

**Other changes in the laws, regulations and policies governing financial services companies could alter our business environment and adversely affect operations.**

The Board of Governors of the Federal Reserve System regulates the supply of money and credit in the United States. Its fiscal and monetary policies determine, in a large part, our cost of funds for lending and investing and the return that can be earned on those loans and investments, both of which affect our net interest margin. Federal Reserve Board policies can also materially affect the value of financial instruments that we hold, such as debt securities and mortgage servicing rights. Recent changes in the laws and regulations that apply to us have been significant. Further dramatic changes in statutes, regulations or policies could affect us in substantial and unpredictable ways, including limiting the types of financial services and products that we offer and/or increasing the ability of non-banks to offer competing financial services and products. We cannot predict whether any of this potential legislation will be enacted, and if enacted, the effect that it or any regulations would have on our financial condition or results of operations.

**The soundness of other financial institutions could adversely affect our liquidity and operations.**

Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. We have exposure to many different counterparties, and we routinely execute transactions with counterparties in the financial industry, including brokers and dealers, commercial banks, investment banks, and other institutional clients. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by Heartland or the Bank Subsidiaries or by other institutions. Many of these transactions expose us to credit risk in the event of default of our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the financial instrument exposure due us. There is no assurance that any such losses would not materially and adversely affect our results of operations.

**Our business is concentrated in and dependent upon the continued growth and welfare of the various markets that we serve.**

We operate over a wide area, including markets in Iowa, Illinois, Wisconsin, Arizona, New Mexico, Montana, Colorado and Minnesota and our financial condition, results of operations and cash flows are subject to changes in the economic conditions in those areas. Our success depends upon the business activity, population, income levels, deposits and real estate activity in those areas. Although our customers' business and financial interests may extend well beyond our market areas, adverse economic conditions that affect our specific market area could reduce our growth rate, affect the ability of our customers to repay their loans to us and generally affect our financial condition and results of operations. For example, although all of our markets have been impacted to some extent by the economic downturn, the markets in Arizona, Colorado and Montana have been more severely affected than most of the markets in the Midwest, creating correspondingly greater impact on our banks that serve those areas.

**Our expansion into new markets through National Residential Mortgage could subject us to economic risks in markets with which we are less familiar.**

We have expanded our residential real estate mortgage production capability by adding personnel and capacity in our Heartland Mortgage and National Residential unit, and have added residential loan production offices with new personnel in several new geographies. Although we have generally sold the mortgages we originate through National Residential Mortgage into the secondary market, we may elect to retain mortgages in our portfolio in the future, and regardless of such retention have some liability as the originator and servicer of the mortgages. If we inaccurately monitor credit risk in these markets, or retain personnel for National Mortgage who do not accurately report and monitor credit risk, our operations could be negatively affected.

**We may experience difficulties in managing our growth and our growth strategy involves risks that may negatively impact our net income.**

As part of our general growth strategy, we may acquire banks and related businesses that we believe provide a strategic and geographic fit with our business. We cannot predict the number, size or timing of acquisitions. To the extent that we grow through acquisitions, we cannot assure you that we will be able to adequately and profitably manage this growth. Acquiring other banks and businesses will involve risks commonly associated with acquisitions, including:

- potential exposure to unknown or contingent liabilities of banks and businesses we acquire;
- exposure to potential asset quality issues of the acquired bank or related business;
- difficulty and expense of integrating the operations and personnel of banks and businesses we acquire;
- potential disruption to our business;
- potential restrictions on our business resulting from the regulatory approval process;
- potential diversion of our management's time and attention; and
- the possible loss of key employees and customers of the banks and businesses we acquire.

In addition to acquisitions, we may expand into additional communities or attempt to strengthen our position in our current markets by undertaking additional *de novo* bank formations or branch openings. Based on our experience, we believe that it generally takes three years or more for new banking facilities to first achieve operational profitability, due to the impact of organization and overhead expenses and the start-up phase of generating loans and deposits. To the extent that we undertake additional branching and *de novo* bank and business formations, we are likely to continue to experience the effects of higher operating expenses relative to operating income from the new operations, which may have an adverse effect on our levels of reported net income, return on average equity and return on average assets.

**Our market and growth strategy relies heavily on our management team, and the unexpected loss of key managers may adversely affect our operations.**

Much of our success to date has been influenced strongly by our ability to attract and to retain senior management experienced in banking and financial services and familiar with the communities in our different market areas. Because our service areas are spread over such a wide geographical area, our management headquartered in Dubuque, Iowa, is dependent on the effective leadership and capabilities of the management in our local markets for the continued success of Heartland. Our ability to retain executive officers, the current management teams and loan officers of our operating subsidiaries will continue to be important to the successful implementation of our strategy. It is also critical, as we grow, to be able to attract and retain qualified additional management and loan officers with the appropriate level of experience and knowledge about our market area to implement our community-based operating strategy. The unexpected loss of services of any key management personnel, or the inability to recruit and retain qualified personnel in the future, could have an adverse effect on our business, financial condition and results of operations.

**We face intense competition in all phases of our business.**

The banking and financial services business in our markets is highly competitive and is currently undergoing significant change. Our competitors include large regional banks, local community banks, thrifts, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market mutual funds, credit unions and other non-bank financial service providers, and increasingly these competitors provide integrated financial services over a broad geographic area. Some of our competitors may also have access to governmental programs that impact their position in the marketplace favorably. Increased competition in our markets may result in a decrease in the amounts of our loans and deposits, reduced spreads between loan rates and deposit rates or loan terms that are more favorable to the borrower. Any of these results could have a material adverse effect on our ability to grow and remain profitable.

## **Interest rates and other conditions impact our results of operations.**

Our profitability is in part a function of the spread between the interest rates earned on investments and loans and the interest rates paid on deposits and other interest-bearing liabilities. Like most banking institutions, our net interest spread and margin will be affected by general economic conditions and other factors, including fiscal and monetary policies of the federal government, that influence market interest rates and our ability to respond to changes in such rates. At any given time, our assets and liabilities will be such that they are affected differently by a given change in interest rates. As a result, an increase or decrease in rates, the length of loan terms or the mix of adjustable and fixed rate loans in our portfolio could have a positive or negative effect on our net income, capital and liquidity. We measure interest rate risk under various rate scenarios and using specific criteria and assumptions. A summary of this process, along with the results of our net interest income simulations, is presented under the heading “Quantitative and Qualitative Disclosures About Market Risk” included under Item 7A of Part II of this Form 10-K. Although we believe our current level of interest rate sensitivity is reasonable and effectively managed, significant fluctuations in interest rates may have an adverse effect on our business, financial condition and results of operations.

## **We must effectively manage our credit risk.**

There are risks inherent in making any loan, including risks inherent in dealing with individual borrowers, risks of nonpayment, risks resulting from uncertainties as to the future value of collateral and risks resulting from changes in economic and industry conditions. We attempt to minimize our credit risk through prudent loan application approval procedures, careful monitoring of the concentration of our loans within specific industries and periodic independent reviews of outstanding loans by our loan review department. However, changes in the economy can cause the assumptions that we made at origination to change and can cause borrowers to be unable to make payments on their loans, and significant changes in collateral values such as those that occurred in 2009 and 2010 can cause us to be unable to collect the full value of loans we make. We cannot assure you that such approval and monitoring procedures will reduce these credit risks.

## **Commercial loans make up a significant portion of our loan portfolio.**

Commercial loans were \$1.81 billion (including \$1.16 billion of commercial real estate loans), or approximately 73% of our total loan portfolio as of December 31, 2011. Our commercial loans are primarily made based on the identified cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. Most often, this collateral consists of accounts receivable, inventory, machinery or real estate. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. The other types of collateral securing these loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business.

## **Our loan portfolio has a large concentration of commercial real estate loans, which involve risks specific to real estate value.**

Commercial real estate lending is a large portion of our commercial loan portfolio. These loans were \$1.16 billion, or approximately 64%, of our total commercial loan portfolio as of December 31, 2011. The market value of real estate can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. Adverse developments affecting real estate values in a few of our markets have negatively affected some of our commercial real estate loans, and further developments could increase the credit risk associated with our loan portfolio. Non-owner occupied commercial real estate loans typically are dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. A weaker economy has an impact on the absorption period associated with lot and land development loans. When the source of repayment is reliant on the successful and timely sale of lots or land held for resale, a default on these loans becomes a greater risk. Economic events or governmental regulations outside of the control of the borrower or lender could negatively impact the future cash flow and market values of the affected properties.

If the problems that have occurred in the commercial real estate markets continue, particularly within our Western market areas, the value of collateral securing our commercial real estate loans may decline and we may not be able to realize the collateral value that we anticipated at the time of originating the loan, causing us to increase our provision for loan losses and adversely affect our operating results and financial condition. Declining real estate values resulting from the recent recession, particularly in our Western markets in Arizona, Colorado and Montana, caused a decline in credit performance by our commercial real estate loan customers and caused us to significantly increase our provision for loan losses during 2008, 2009, 2010 and a portion of 2011, negatively impacting our financial performance. In light of the uncertainty that exists in the economy and credit markets nationally, there can be no guarantee that we will not experience recurring deterioration in such performance.



Our commercial real estate loans also include commercial construction loans, including land acquisition and development, which involve additional risks because funds are advanced based upon estimates of costs and the estimated value of the completed project. Because of the uncertainties inherent in estimating construction costs, as well as the market value of the completed project and the effects of governmental regulation on real property, it is relatively difficult to evaluate accurately the total funds required to complete a project and the related loan-to-value ratio. As a result, commercial construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property, rather than the ability of the borrower or guarantor to repay principal and interest. If our appraisal of the value of the completed project proves to be overstated, we may have inadequate security for the repayment of the loan upon completion of construction of the project. Additionally, with the ongoing economic environment and the correction in housing prices that is occurring in many of our market areas, a decrease in demand for the properties constructed by home builders and developers could result in higher delinquencies and greater charge-offs in future periods on loans made to such borrowers.

**Our one- to four-family residential mortgage loans may result in lower yields and profitability.**

One- to four-family residential mortgage loans comprised \$194.4 million or 8% of our loan and lease portfolio at December 31, 2011, and are secured primarily by properties located in the Midwest. These loans generally result in lower yields and lower profitability for us than other loans in Heartland's portfolio and are generally made on the basis of the borrower's ability to make repayments from his or her employment and the value of the property securing the loan.

**Revenue from our mortgage banking operations is sensitive to changes in economic conditions, decreased economic activity, a slowdown in the housing market, higher interest rates or new legislation and may adversely impact our profits.**

Our mortgage banking division, Heartland Mortgage, will potentially provide a significant portion of our consolidated revenue and maintaining our revenue stream in this segment is dependent upon our ability to originate loans and sell them to investors. Mortgage loan production levels are sensitive to changes in economic conditions and can suffer from decreased economic activity, a slowdown in the housing market or higher interest rates. Generally, any sustained period of decreased economic activity or higher interest rates could adversely affect mortgage originations and, consequently, reduce our income from mortgage lending activities. In addition, new legislation could adversely affect operations.

Deteriorating economic conditions may also cause home buyers to default on their mortgages. In certain of these cases where Heartland Mortgage has originated loans and sold them to investors, it may be required to repurchase loans or provide a financial settlement to investors if it is proven that the borrower failed to provide full and accurate information on or related to their loan application or for which appraisals have not been acceptable or when the loan was not underwritten in accordance with the loan program specified by the loan investor. Such repurchases or settlements would also adversely affect our net income.

**Periods of rising interest rates will adversely affect income from mortgage banking activities**

In periods of rising interest rates, consumer demand for new mortgages and re-financings decreases which in turn, adversely impacts our mortgage banking division. Because interest rates depend on factors outside of our control, we cannot eliminate the interest rate risk associated with our mortgage operations.

**Our consumer loans generally have a higher degree of risk of default than our other loans.**

At December 31, 2011, consumer loans totaled \$220.1 million or 9% of our total loan and lease portfolio. Consumer loans typically have shorter terms and lower balances with higher yields as compared to one- to four-family residential mortgage loans, but generally carry higher risks of default. Consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount that can be recovered on these loans.

**Our agricultural loans may involve a greater degree of risk than other loans, and the ability of the borrower to repay may be affected by many factors outside of the borrower's control.**

At December 31, 2011, agricultural real estate loans totaled \$178.8 million or 7% of our total loan and lease portfolio. Payments on agricultural real estate loans are dependent on the profitable operation or management of the farm property

securing the loan. The success of the farm may be affected by many factors outside the control of the borrower, including adverse weather conditions that prevent the planting of a crop or limit crop yields (such as hail, drought and floods), loss of livestock due to disease or other factors, declines in market prices for agricultural products (both domestically and internationally) and the impact of government regulations (including changes in price supports, subsidies and environmental regulations). In addition, many farms are dependent on a limited number of key individuals whose injury or death may significantly affect the successful operation of the farm. If the cash flow from a farming operation is diminished, the borrower's ability to repay the loan may be impaired. The primary crops in our market areas are corn, soybeans, peanuts and wheat. Accordingly, adverse circumstances affecting these crops could have an adverse effect on our agricultural real estate loan portfolio.

We also originate agricultural operating loans. At December 31, 2011, these loans totaled \$84.1 million or 3% of our total loan and lease portfolio. As with agricultural real estate loans, the repayment of operating loans is dependent on the successful operation or management of the farm property. Likewise, agricultural operating loans involve a greater degree of risk than lending on residential properties, particularly in the case of loans that are unsecured or secured by rapidly depreciating assets such as farm equipment or assets such as livestock or crops. The primary livestock in our market areas include dairy cows, hogs and feeder cattle. In these cases, any repossessed collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation.

**Our allowance for loan losses may prove to be insufficient to absorb losses in our loan portfolio.**

We establish our allowance for loan losses in consultation with management of the Bank Subsidiaries and maintain it at a level considered adequate by management to absorb probable loan losses that are inherent in the portfolio. The amount of future loan losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates, which may be beyond our control, and such losses may exceed current estimates. Throughout 2008, 2009, 2010 and 2011, we were required to record provisions for loan losses in excess of our pre-2008 historical experience because of the impact of the economy and real estate values on some of our borrowers, resulting in charge-offs and an increased level of nonperforming assets. At December 31, 2011, our allowance for loan losses as a percentage of total loans, exclusive of loans covered by loss share agreements, was 1.48% and as a percentage of total nonperforming loans was approximately 64%. Although we believe that the allowance for loan losses is adequate to absorb losses on any existing loans that may become uncollectible, we cannot predict loan losses with certainty, and we cannot assure you that our allowance for loan losses will prove sufficient to cover actual loan losses in the future. Further significant provisions, or charge-offs against our allowance that result in provisions, could have a significant negative impact on our profitability. Loan losses in excess of our reserves may adversely affect our business, financial condition and results of operations.

**Impairment of investment securities, goodwill, other intangible assets, or deferred tax assets could require charges to earnings, which could result in a negative impact on our results of operations.**

We maintained a balance of \$1.33 billion, or nearly 31% of our assets, in investment securities at December 31, 2011, and must periodically test our investment securities for impairment in value. In assessing whether the impairment of investment securities is other-than-temporary, we consider the length of time and extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability to retain our investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value in the near term. Under current accounting standards, goodwill is not amortized but, instead, is subject to impairment tests on at least an annual basis or more frequently if an event occurs or circumstances change that reduce the fair value of a reporting unit below its carrying amount. During 2009, we recorded \$12.7 million in goodwill impairment charges at Arizona Bank & Trust and Rocky Mountain Bank. An additional \$1.6 million goodwill impairment charge was recorded at Rocky Mountain Bank in 2010. Although we do not presently anticipate additional impairment charges, if we conclude that additional amounts of our goodwill may be impaired, a non-cash charge for the amount of such impairment would be recorded against earnings. Such a charge would have no impact on tangible capital. A decline in our stock price or occurrence of a triggering event following any of our quarterly earnings releases and prior to the filing of the periodic report for that period could, under certain circumstances, cause us to perform a goodwill impairment test and result in an impairment charge being recorded for that period which was not reflected in such earnings release. At December 31, 2011, we had goodwill of \$25.9 million, representing approximately 7% of stockholders' equity.

Further, our balance sheet reflected approximately \$25.9 million of deferred tax assets at December 31, 2011, that represents differences in the timing of the benefit of deductions, credits and other items for accounting purposes and the benefit for tax purposes. To the extent we conclude that the value of this asset is not more likely than not to be realized, we would be obligated to record a valuation allowance against the asset, impacting our earnings during the period in which the valuation allowance is recorded. Assessing the need for, or the sufficiency of, a valuation allowance requires management to evaluate all available evidence, both negative and positive. Positive evidence necessary to overcome the negative evidence includes whether future

taxable income in sufficient amounts and character within the carryback and carryforward periods is available under the tax law. When negative evidence (e.g., cumulative losses in recent years, history of operating losses or tax credit carryforwards expiring unused) exists, more positive evidence than negative evidence will be necessary. If the positive evidence is not sufficient to exceed the negative evidence, a valuation allowance for deferred tax assets is established. The impact of each of these impairment matters could have a material adverse effect on our business, results of operations, and financial condition.

**Our mortgage banking revenue can be volatile from quarter to quarter, including as a result of changes in interest rates and the value of our mortgage servicing rights and our loans held for sale, and we rely on Government Sponsored Entities ("GSE") to purchase our conforming loans to reduce our credit risk and provide liquidity to fund new liquidity mortgage loans.**

A mortgage servicing right ("MSR") is the right to service a mortgage loan for a fee. We acquire MSRs when we originate mortgage loans and keep the servicing rights after we sell the loans. We carry MSRs at the lower of amortized cost or estimated fair value. Fair value is the present value of estimated future net servicing income, calculated based on a number of variables, including assumptions about the likelihood of prepayment by borrowers. Changes in interest rates can affect prepayment assumptions. When interest rates fall, borrowers are more likely to prepay their mortgage loans by refinancing them at a lower rate. As the likelihood of prepayment increases, the fair value of our MSRs can decrease. Each quarter we evaluate our MSRs for impairment based on the difference between the carrying amount and fair value. If temporary impairment exists, we establish a valuation allowance through a charge to earnings for the amount by which the carrying amount exceeds fair value.

We typically use derivatives and other instruments to hedge changes in the value of loans held for sale. We generally do not hedge all of our risk, and we may not be successful in hedging any of the risk. Hedging is a complex process, requiring sophisticated models and constant monitoring, and is not a perfect science. We may use hedging instruments that may not perfectly correlate with the value or income being hedged. We could incur significant losses from our hedging activities. There may be periods where we elect not to use derivatives and other instruments to hedge mortgage banking interest rate risk.

We sell most of the mortgage loans we originate in order to reduce our credit risk and provide funding for additional loans. We rely on GSEs to purchase loans that meet their conforming loan requirements and on other capital markets investors to purchase loans that do not meet those requirements - referred to as "nonconforming" loans. During the past few years investor demand for nonconforming loans has fallen sharply, increasing credit spreads and reducing the liquidity for those loans. In response to the reduced liquidity in the capital markets, we may retain more nonconforming loans. When we retain a loan, not only do we keep the credit risk of the loan, but we also do not receive any sale proceeds that could be used to generate new loans. Continued lack of liquidity could limit our ability to fund - and thus originate - new mortgage loans, reducing the fees we earn from originating and servicing loans. In addition, we cannot assure that GSEs will not materially limit their purchases of conforming loans, including because of capital constraints or changes in their criteria for conforming loans (e.g., maximum loan amount or borrower eligibility). Each of the GSEs is currently in conservatorship, with its primary regulator, the Federal Housing Agency acting as conservator. We cannot predict if, when or how the conservatorship will end, or any associated changes to the business structure and operations of the GSEs that could result. As noted above, there are various proposals to reform the housing finance market in the U.S., including the role of the GSEs in the housing finance market. The extent and timing of any such regulatory reform regarding the housing finance market and the GSEs, including whether the GSEs will continue to exist in their current form, as well as any effect on Heartland's business and financial results, are uncertain.

**We may be required to repurchase mortgage loans or reimburse investors and others as a result of breaches in contractual representations and warranties.**

We sell residential mortgage loans to various parties, including GSEs and other financial institutions that purchase mortgage loans for investment or private label securitization. The agreements under which we sell mortgage loans and the insurance or guaranty agreements with the FHA and VA contain various representations and warranties regarding the origination and characteristics of the mortgage loans, including ownership of the loan, compliance with loan criteria set forth in the applicable agreement, validity of the lien securing the loan, absence of delinquent taxes or liens against the property securing the loan, and compliance with applicable origination laws. We may be required to repurchase mortgage loans, indemnify the investor or insurer, or reimburse the investor or insurer for credit losses incurred on loans in the event of a breach of contractual representations or warranties that is not remedied within a period (usually 90 days or less) after we receive notice of the breach. Contracts for mortgage loan sales to the GSEs include various types of specific remedies and penalties that could be applied to inadequate responses to repurchase requests. Similarly, the agreements under which we sell mortgage loans require us to deliver various documents to the investor, and we may be obligated to repurchase any mortgage loan as to which the required documents are not delivered or are defective. We establish a mortgage repurchase liability related to the various representations and warranties that reflect management's estimate of losses for loans which we have a repurchase obligation. Our mortgage repurchase liability represents management's best estimate of the probable loss that we may expect to incur for the

representations and warranties in the contractual provisions of our sales of mortgage loans. Because the level of mortgage loan repurchase losses depends upon economic factors, investor demand strategies and other external conditions that may change over the life of the underlying loans, the level of the liability for mortgage loan repurchase losses is difficult to estimate and requires considerable management judgment. If economic conditions and the housing market do not improve or future investor repurchase demand and our success at appealing repurchase requests differ from past experience, we could continue to have increased repurchase obligations and increased loss severity on repurchases, requiring additions to the repurchase liability.

**Our growth may require us to raise additional capital in the future, but that capital may not be available when it is needed.**

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. We anticipate that our existing capital resources will satisfy our capital requirements for the foreseeable future. However, we may at some point need to raise additional capital to support continued growth, both internally and through acquisitions. Our ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside of our control, and on our financial performance. Accordingly, we cannot assure you of our ability to raise additional capital if needed on terms acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth and acquisitions could be materially impaired.

**Government regulation can result in limitations on our operations.**

We operate in a highly regulated environment and are subject to supervision and regulation by a number of governmental regulatory agencies, including the Federal Reserve, the FDIC, and the various state agencies where we have a bank presence. Regulations adopted by these agencies, which are generally intended to provide protection for depositors and customers rather than for the benefit of stockholders, govern a comprehensive range of matters relating to ownership and control of our shares, our acquisition of other companies and businesses, permissible activities for us to engage in, maintenance of adequate capital levels and other aspects of our operations. These bank regulators possess broad authority to prevent or remedy unsafe or unsound practices or violations of law deemed to be unfair, abusive and deceptive acts and practices. The laws and regulations applicable to the banking industry could change at any time and we cannot predict the effects of these changes on our business and profitability. Increased regulation could increase our cost of compliance and adversely affect profitability. For example, new legislation or regulation may limit the manner in which we may conduct our business, including our ability to offer new products, obtain financing, attract deposits, make loans and achieve satisfactory interest spreads.

**We have a continuing need for technological change and we may not have the resources to effectively implement new technology.**

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to being able to better serve customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience, as well as, to create additional efficiencies in our operations as we continue to grow and expand our market areas. Many of our larger competitors have substantially greater resources to invest in technological improvements. As a result, they may be able to offer additional or superior products to those that we will be able to offer, which would put us at a competitive disadvantage.

**System failure or breaches of our network security could subject us to increased operating costs as well as litigation and other liabilities.**

The computer systems and network infrastructure we use could be vulnerable to unforeseen problems. Our operations are dependent upon our ability to protect our computer equipment against damage from physical theft, fire, power loss, telecommunications failure or a similar catastrophic event, as well as from security breaches, denial of service attacks, viruses, worms and other disruptive problems caused by hackers. Any damage or failure that causes an interruption in our operations could have a material adverse effect on our financial condition and results of operations. Computer break-ins, phishing and other disruptions could also jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure, which may result in significant liability to us and may cause existing and potential customers to refrain from doing business with us. Although we, with the help of third-party service providers, intend to continue to implement security technology and establish operational procedures to prevent such damage, there can be no assurance that these security measures will be successful. In addition, advances in computer capabilities, new discoveries in the field of cryptography or other developments could result in a compromise or breach of the algorithms we and our third-party service providers use to encrypt and protect customer transaction data. A failure of such security measures could have a material adverse effect on our financial condition and results of operations.

**We are subject to certain operational risks, including, but not limited to, customer or employee fraud and data processing system failures and errors.**

Employee errors and employee or customer misconduct could subject us to financial losses or regulatory sanctions and seriously harm our reputation. Misconduct by our employees could include hiding unauthorized activities from us, improper or unauthorized activities on behalf of our customers or improper use of confidential information. It is not always possible to prevent employee errors and misconduct, and the precautions we take to prevent and detect this activity may not be effective in all cases. Employee errors could also subject us to financial claims for negligence.

We maintain a system of internal controls and insurance coverage to mitigate against operational risks, including data processing system failures and errors and customer or employee fraud. Should our internal controls fail to prevent or detect an occurrence, or if any resulting loss is not insured or exceeds applicable insurance limits, it could have a material adverse effect on our business, financial condition and results of operations.

**Negative publicity could adversely impact our business and financial results.**

Reputation risk, or the risk to our earnings and capital from negative publicity, is inherent to our business. Current public uneasiness with the United States banking system heightens this risk, as banking customers often transfer news regarding financial difficulties or even failure of some institutions, to fear of financial difficulty or failure of even the most secure institutions. In this climate, any negative news may become cause for curtailment of business relationships, withdrawal of funds or other actions that can have a compounding effect, and could adversely affect our operations.

**Our stock price can be volatile.**

Our stock price can fluctuate widely in response to a variety of factors, including: actual or anticipated variations in our quarterly operating results; recommendations by securities analysts; acquisitions or business combinations; capital commitments by or involving Heartland or our Bank Subsidiaries; operating and stock price performance of other companies that investors deem comparable to us; new technology used or services offered by our competitors; new reports relating to trends, concerns and other issues in the financial services industry; and changes in government regulations. General market fluctuations, industry factors and general economic and political conditions and events have recently caused a decline in our stock price, and these factors, as well as, interest rate changes, continued unfavorable credit loss trends, or unforeseen events such as terrorist attacks could cause our stock price to remain volatile regardless of our operating results.

**Certain Bank Subsidiaries are subject to informal written agreements with regulators and failure to comply with these agreements could result in enforcement actions against us.**

Four of our Bank Subsidiaries have entered into informal written agreements with the FDIC and state regulators, which relate primarily to financial performance and credit quality. These Bank Subsidiaries have submitted three to five year business plans to their regulators and must operate within the parameters of these business plans and submit periodic reports on compliance with these plans. The agreements also require these Bank Subsidiaries to develop plans and take action to address nonperforming assets and watch-list credits. If these Bank Subsidiaries fail to comply with the terms of their respective agreements, the regulators could take enforcement action against them, including the imposition of monetary penalties or the issuance of cease and desist orders requiring corrective action.

**ITEM 1B.**

**UNRESOLVED STAFF COMMENTS**

As of December 31, 2011, Heartland had no unresolved staff comments.

**ITEM 2.****PROPERTIES**

The following table is a listing of Heartland's principal operating facilities:

| <b>Name and Main Facility Address</b>  | <b>Main Facility Square Footage</b> | <b>Main Facility Owned or Leased</b> | <b>Number of Locations</b> |
|--|-------------------------------------|--------------------------------------|----------------------------|
| Heartland Financial USA, Inc.<br>1301 Central Avenue<br>Dubuque, IA 52001        | 60,000                              | Owned                                | 2                          |
| Dubuque Bank and Trust Company<br>1398 Central Avenue<br>Dubuque, IA 52001       | 65,500                              | Owned                                | 12                         |
| Galena State Bank & Trust Co.<br>971 Gear Street<br>Galena, IL 61036             | 18,000                              | Owned                                | 4                          |
| Riverside Community Bank<br>6855 E. Riverside Blvd.<br>Rockford, IL 60114        | 8,000                               | Owned                                | 4                          |
| Wisconsin Community Bank<br>8240 Mineral Point Rd.<br>Madison, WI 53719          | 19,000                              | Owned                                | 7                          |
| New Mexico Bank & Trust<br>320 Gold NW<br>Albuquerque, NM 87102                  | 11,400                              | Lease term through 2016              | 16                         |
| Arizona Bank & Trust<br>2036 E. Camelback Rd.<br>Phoenix, AZ 85016               | 14,000                              | Owned                                | 6                          |
| Rocky Mountain Bank<br>2615 King Avenue West<br>Billings, MT 59102               | 16,600                              | Owned                                | 9                          |
| Summit Bank & Trust<br>2002 E. Coalton Road<br>Broomfield, CO 80027              | 14,000                              | Owned                                | 3                          |
| Minnesota Bank & Trust<br>7701 France Avenue South, Suite 110<br>Edina, MN 55435 | 6,100                               | Lease term through 2013              | 1                          |
| Citizens Finance Co.<br>1275 Main Street<br>Dubuque, IA 52001                    | 5,600                               | Owned                                | 10                         |

The corporate office of Heartland is located in Dubuque Bank and Trust Company's main office. A majority of the support functions provided to the Bank Subsidiaries by Heartland are performed in the facility located at 1301 Central Avenue in Dubuque, Iowa, which is leased from Dubuque Bank and Trust Company.

**ITEM 3.****LEGAL PROCEEDINGS**

There are no material pending legal proceedings to which Heartland or its subsidiaries are a party at December 31, 2011, other than ordinary routine litigation incidental to their respective businesses. While the ultimate outcome of current legal proceedings cannot be predicted with certainty, it is the opinion of management that the resolution of these legal actions should not have a material effect on Heartland's consolidated financial position or results of operations.

#### ITEM 4.

#### MINE SAFETY DISCLOSURES

Not Applicable

#### EXECUTIVE OFFICERS

The names and ages of the executive officers of Heartland as of December 31, 2011, position held by these officers on that date and other positions held with Heartland and its subsidiaries are set forth below:

| Name                 | Age | Position with Heartland and Subsidiaries and Principal Occupation   |
|----------------------|-----|---|
| Lynn B. Fuller       | 62  | Chairman, President and Chief Executive Officer of Heartland; Vice Chairman of Dubuque Bank and Trust Company, Wisconsin Community Bank, New Mexico Bank & Trust, Arizona Bank & Trust, Rocky Mountain Bank, Summit Bank & Trust and Minnesota Bank & Trust; Chairman of Citizens Finance Co. |
| John K. Schmidt      | 52  | Director, Executive Vice President, Chief Operating Officer and Chief Financial Officer of Heartland; Vice Chairman of Dubuque Bank and Trust Company, Galena State Bank & Trust Co. and Riverside Community Bank; Director and Treasurer of Citizens Finance Co.                             |
| Kenneth J. Erickson  | 60  | Executive Vice President, Chief Credit Officer of Heartland; Executive Vice President, Lending, of Dubuque Bank and Trust Company; Vice Chairman of Citizens Finance Co.  |
| Douglas J. Horstmann | 58  | Senior Vice President, Lending, of Heartland; Director, President and Chief Executive Officer of Dubuque Bank and Trust Company   |
| Melvin E. Miller     | 62  | Executive Vice President, Chief Investment Officer of Heartland   |
| John J. Berg         | 60  | Executive Vice President, Marketing and Sales of Heartland  |
| Brian J. Fox         | 63  | Executive Vice President, Operations of Heartland   |

Lynn B. Fuller has been a Director of Heartland and of Dubuque Bank and Trust Company since 1984 and has been President of Heartland since 1987. Until 2004, Mr. Fuller had been a Director of Galena State Bank & Trust Co. since 1992 and Riverside Community Bank since 1995. He has been a Director of Wisconsin Community Bank since 1997, New Mexico Bank & Trust since 1998, Arizona Bank & Trust since 2003, Summit Bank & Trust since 2006 and Minnesota Bank & Trust since 2008. Mr. Fuller joined Dubuque Bank and Trust Company in 1971 as a consumer loan officer and was named Dubuque Bank and Trust Company's Executive Vice President and Chief Executive Officer in 1985. Mr. Fuller was President of Dubuque Bank and Trust Company from 1987 until 1999 at which time he was named Chief Executive Officer of Heartland. Mr. Fuller is the brother-in-law of Mr. James F. Conlan, who is a director of Heartland.

John K. Schmidt has been a Director of Heartland since 2001. Mr. Schmidt has been Heartland's Executive Vice President and Chief Financial Officer since 1991 and Chief Operating Officer since 2004. He has been employed by Dubuque Bank and Trust Company since 1984 and became Dubuque Bank and Trust Company's Vice President, Finance in 1986, Senior Vice President and Chief Financial Officer in 1991, President and Chief Executive Officer in 1999 and Vice Chairman in 2004. Mr. Schmidt also was named Vice Chairman of Galena State Bank & Trust Co. and Riverside Community Bank in 2004. He also served as Vice Chairman and director of First Community Bank from 2004 to 2007. He is an inactive holder of the certified public accountant certification and worked at KPMG LLP in Des Moines, Iowa, prior to joining Dubuque Bank and Trust Company.

Kenneth J. Erickson was named Executive Vice President, Chief Credit Officer, of Heartland in 1999. Mr. Erickson has been employed by Dubuque Bank and Trust Company since 1975, and was appointed Vice President, Commercial Loans in 1985, Senior Vice President, Lending in 1989 and Executive Vice President in 2000. He was named Vice Chairman of Citizens Finance Co. in 2004. Prior to 2004, Mr. Erickson was Senior Vice President at Citizens Finance Co.

Douglas J. Horstmann has served as Senior Vice President of Heartland since 1999. He has been employed by Dubuque Bank and Trust Company since 1980, was appointed Vice President, Commercial Loans in 1985, Senior Vice President, Lending in 1989, Executive Vice President, Lending in 2000 and Director, President and Chief Executive Officer in 2004. Mr. Horstmann also served as Vice Chairman of First Community Bank from 2007 until its merger with Dubuque Bank and Trust Company in 2011. Prior to joining Dubuque Bank and Trust Company, Mr. Horstmann was an examiner for the Iowa Division of Banking.



Melvin E. Miller was named Executive Vice President, Chief Investment Officer, of Heartland, in 2008. Prior to this promotion, he served as Senior Vice President, Chief Investment Officer, of Heartland since 2000. He joined Dubuque Bank and Trust Company in 1984 as a part-time Investment Officer and came on board full time in 1985 as Assistant Vice President and later was promoted to Senior Vice President and Chief Investment Officer. A Chartered Financial Analyst, Mr. Miller received his MBA degree in Finance from Ball State University in 1973. Prior to joining Dubuque Bank and Trust Company, he had 12 years of college teaching experience in the areas of investments and portfolio management. He was chair of the Department of Accounting and Business at Loras College. Mr. Miller announced his retirement on February 3, 2012. His retirement will be effective on August 1, 2012.

John J. Berg joined Heartland in 2005 as Senior Vice President, Marketing and Sales. In 2008, he was promoted to Executive Vice President, Marketing and Sales. Mr. Berg's background includes over 30 years of retail marketing and banking experience. Previous to joining Heartland, Mr. Berg served as Vice President and Marketing Director of First Federal Capital Bank in LaCrosse, Wisconsin. His prior experience includes marketing management positions with commercial banks and savings banks in West Des Moines, Iowa; St. Louis, Missouri; Waterloo, Iowa; and Lansing, Michigan.

Brian J. Fox joined Heartland in 2010 as Executive Vice President, Operations. From 2008 until joining Heartland, Mr. Fox served as Chief Information Officer of First Olathe Bancshares in Overland Park, Kansas. One year after joining First Olathe Bancshares, he was asked to help its principal subsidiary, First National Bank of Olathe, comply with a formal agreement it had entered with the Office of the Comptroller of the Currency (the "OCC") and served as its Chief Risk Officer. In October 2011, First National Bank of Olathe was placed in receivership by the OCC. For the eight years prior to joining First Olathe Bancshares, Mr. Fox drew on his 30 years experience at various banking organizations to provide consulting services to over 100 community banks as Senior Consultant at Vitex, Inc. His areas of responsibility have included strategic planning, credit administration, loan workouts, information technology, project management, mortgage banking, deposit operations and loan operations.

## PART II

### ITEM 5.

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

Heartland's common stock was held by approximately 1,500 stockholders of record as of March 14, 2012, and approximately 1,600 additional stockholders held shares in street name. The common stock of Heartland has been quoted on the NASDAQ Stock Market since May 2003 under the symbol "HTLF" and is a NASDAQ Global Select Market security.

For the periods indicated, the following table shows the range of reported prices per share of Heartland's common stock in the NASDAQ Global Select Market. These quotations represent inter-dealer prices without retail markups, markdowns, or commissions and do not necessarily represent actual transactions.

| <b>Heartland Common Stock</b> |             |            |
|-------------------------------|-------------|------------|
| <b>Calendar Quarter</b>       | <b>High</b> | <b>Low</b> |
| 2011:                         |             |            |
| First                         | \$18.38     | \$14.55    |
| Second                        | 17.75       | 13.20      |
| Third                         | 16.47       | 12.65      |
| Fourth                        | 17.25       | 12.81      |
| 2010:                         |             |            |
| First                         | \$16.75     | \$13.37    |
| Second                        | 20.78       | 15.85      |
| Third                         | 17.81       | 13.88      |
| Fourth                        | 18.11       | 15.04      |

Cash dividends have been declared by Heartland quarterly during the two years ending December 31, 2011. The following table sets forth the cash dividends per share paid on Heartland's common stock for the past two years:

| <b>Calendar Quarter</b> | <b>2011</b> | <b>2010</b> |
|-------------------------|-------------|-------------|
| First                   | \$ 0.10     | \$ 0.10     |
| Second                  | 0.10        | 0.10        |
| Third                   | 0.10        | 0.10        |
| Fourth                  | 0.10        | 0.10        |

Heartland's ability to pay dividends to stockholders is largely dependent upon the dividends it receives from the Bank Subsidiaries, and the Bank Subsidiaries are subject to regulatory limitations on the amount of cash dividends they may pay. Heartland is also subject to direct regulatory limitations on the amount of dividends it may pay under the terms of its Series C Preferred Stock issued under the SBLF. See "Business – Supervision and Regulation – Heartland – Dividend Payments" and "Business – Supervision and Regulation - The Bank Subsidiaries – Dividend Payments" and "Note 17 Capital Issuance and Redemption to Consolidated Financial Statements" for a more detailed description of these limitations.

Heartland has issued junior subordinated debentures in several private placements. Under the terms of the debentures, Heartland may be prohibited, under certain circumstances, from paying dividends on shares of its common stock. None of these circumstances currently exist.

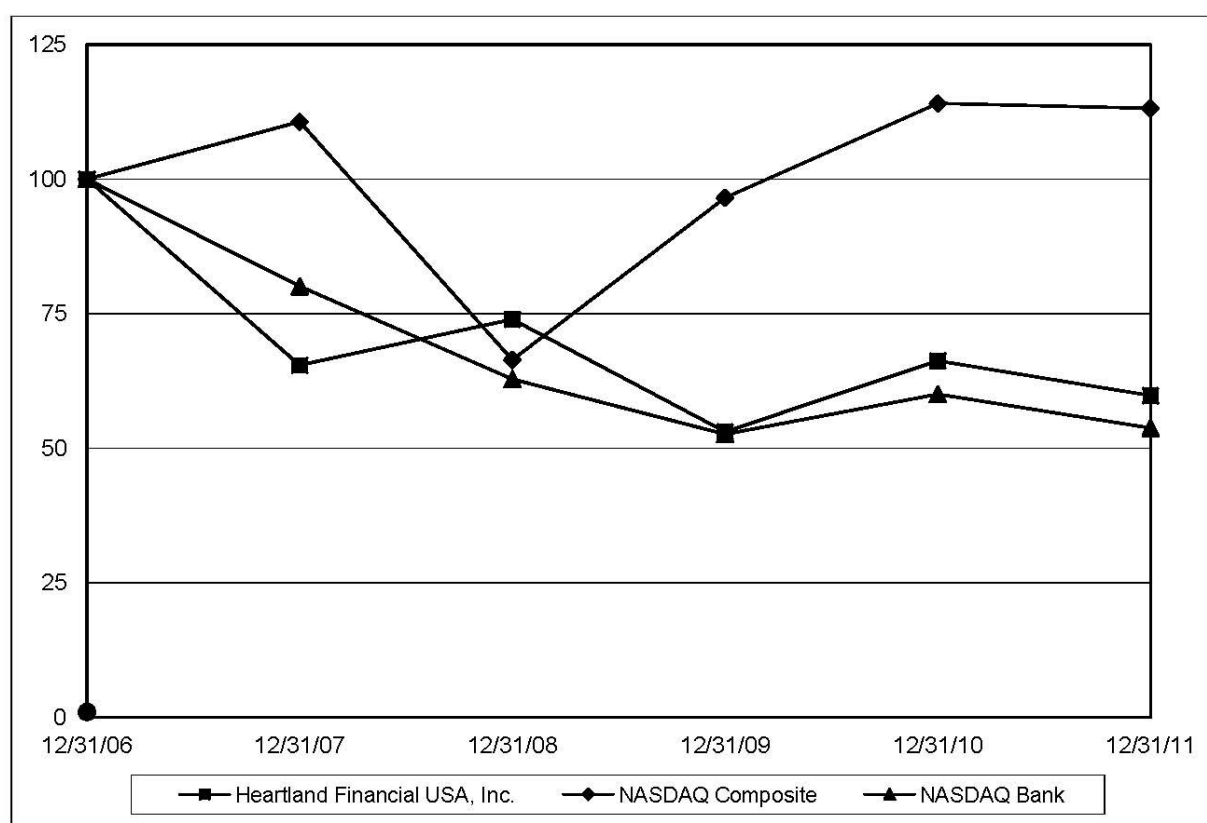
There were no unregistered sales of equity securities made during the fourth quarter of Heartland's fiscal year 2011.

The following table and graph show a five-year comparison of cumulative total returns for Heartland, the NASDAQ Composite Index and the NASDAQ Bank Stock Index. Figures for our common stock represent inter-dealer quotations, without retail markups, markdowns or commissions and do not necessarily represent actual transactions. Heartland became listed on NASDAQ in May 2004. The table and graph were prepared at our request by SNL Financial, LC.

#### Cumulative Total Return Performance

|                               | 12/31/2006 | 12/31/2007 | 12/31/2008 | 12/31/2009 | 12/31/2010 | 12/31/2011 |
|-------------------------------|------------|------------|------------|------------|------------|------------|
| Heartland Financial USA, Inc. | \$ 100.00  | \$ 65.43   | \$ 73.95   | \$ 53.04   | \$ 66.22   | \$ 59.79   |
| NASDAQ Composite              | \$ 100.00  | \$ 110.66  | \$ 66.42   | \$ 96.54   | \$ 114.06  | \$ 113.16  |
| NASDAQ Bank                   | \$ 100.00  | \$ 80.09   | \$ 62.84   | \$ 52.60   | \$ 60.04   | \$ 53.74   |

#### COMPARISON OF FIVE YEAR CUMULATIVE TOTAL RETURN\* ASSUMES \$100 INVESTED ON DECEMBER 31, 2006



\*Total return assumes reinvestment of dividends

**ITEM 6.****SELECTED FINANCIAL DATA**

For the years ended December 31, 2011, 2010, 2009, 2008 and 2007

(Dollars in thousands, except per share data)

|   | <b>2011</b>      | <b>2010</b>      | <b>2009</b>     | <b>2008</b>      | <b>2007</b>      |
|---|------------------|------------------|-----------------|------------------|------------------|
| <b>STATEMENT OF INCOME DATA</b>   |                  |                  |                 |                  |                  |
| Interest income   | \$ 191,737       | \$ 198,932       | \$ 203,293      | \$ 202,585       | \$ 215,231       |
| Interest expense  | 46,343           | 55,880           | 70,530          | 86,899           | 105,891          |
| Net interest income   | 145,394          | 143,052          | 132,763         | 115,686          | 109,340          |
| Provision for loan and lease losses   | 29,365           | 32,508           | 39,377          | 29,319           | 10,073           |
| Net interest income after provision for loan and lease losses                   | 116,029          | 110,544          | 93,386          | 86,367           | 99,267           |
| Noninterest income  | 59,577           | 52,329           | 52,704          | 30,196           | 31,710           |
| Noninterest expenses  | 137,296          | 129,239          | 132,520         | 102,239          | 97,606           |
| Income taxes  | 10,302           | 9,846            | 7,196           | 3,312            | 9,409            |
| Income from continuing operations   | 28,008           | 23,788           | 6,374           | 11,012           | 23,962           |
| Discontinued operations:  |                  |                  |                 |                  |                  |
| Income from discontinued operations (including gain on sale of \$2,242 in 2007) | —                | —                | —               | —                | 2,756            |
| Income taxes  | —                | —                | —               | —                | 1,085            |
| Income from discontinued operations   | —                | —                | —               | —                | 1,671            |
| Net income  | 28,008           | 23,788           | 6,374           | 11,012           | 25,633           |
| Net income available to noncontrolling interest, net of tax                     | 36               | 115              | 188             | 280              | —                |
| Net income attributable to Heartland  | 28,044           | 23,903           | 6,562           | 11,292           | 25,633           |
| Preferred dividends and discount  | (7,640)          | (5,344)          | (5,344)         | (178)            | —                |
| Net income available to common stockholders                                     | <u>\$ 20,404</u> | <u>\$ 18,559</u> | <u>\$ 1,218</u> | <u>\$ 11,114</u> | <u>\$ 25,633</u> |
| <b>PER COMMON SHARE DATA</b>  |                  |                  |                 |                  |                  |
| Net income – diluted  | \$ 1.23          | \$ 1.13          | \$ 0.07         | \$ 0.68          | \$ 1.54          |
| Income from continuing operations – diluted <sup>(1)</sup>                      | 1.23             | 1.13             | 0.07            | 0.68             | 1.44             |
| Cash dividends  | 0.40             | 0.40             | 0.40            | 0.40             | 0.37             |
| Dividend payout ratio   | 32.52%           | 35.14%           | 53.24%          | 58.13%           | 23.60%           |
| Book value  | \$ 16.29         | \$ 15.26         | \$ 14.38        | \$ 14.13         | \$ 14.04         |
| Weighted average shares outstanding-diluted                                     | 16,575,506       | 16,461,679       | 16,325,320      | 16,365,815       | 16,596,806       |

(1) Excludes the discontinued operations of our Broadus branch and the related gain on sale in 2007.

\* The selected historical consolidated financial information set forth above is qualified in its entirety by reference to, and should be read in conjunction with, Heartland's consolidated financial statements and notes thereto, included elsewhere in this report and Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations."

**SELECTED FINANCIAL DATA (Continued)**

For the years ended December 31, 2011, 2010, 2009, 2008 and 2007

(Dollars in thousands, except per share data)

|                                     | 2011         | 2010         | 2009         | 2008       | 2007       |
|-------------------------------------|--------------|--------------|--------------|------------|------------|
| <b>BALANCE SHEET DATA</b>           |              |              |              |            |            |
| Investments and federal funds sold  | \$ 1,326,794 | \$ 1,264,564 | \$ 1,175,217 | \$ 903,705 | \$ 689,949 |
| Loans held for sale                 | 53,528       | 23,904       | 17,310       | 19,695     | 12,679     |
| Total loans and leases receivable   | 2,494,631    | 2,364,787    | 2,363,002    | 2,405,001  | 2,280,167  |
| Allowance for loan and lease losses | 36,808       | 42,693       | 41,848       | 35,651     | 32,993     |
| Total assets                        | 4,305,058    | 3,999,455    | 4,012,991    | 3,630,268  | 3,264,126  |
| Total deposits                      | 3,210,113    | 3,034,048    | 3,050,389    | 2,640,232  | 2,376,299  |
| Long-term obligations               | 372,820      | 362,527      | 451,429      | 437,833    | 263,607    |
| Preferred equity                    | 81,698       | 78,483       | 77,224       | 75,578     | —          |
| Common stockholders' equity         | 268,520      | 250,608      | 235,057      | 230,025    | 230,600    |

|   |       |       |       |       |       |
|---|-------|-------|-------|-------|-------|
| <b>EARNINGS PERFORMANCE DATA</b>            |       |       |       |       |       |
| Return on average total assets              | 0.50% | 0.46% | 0.03% | 0.33% | 0.81% |
| Return on average stockholders' equity      | 7.77  | 7.51  | 0.51  | 4.84  | 11.88 |
| Net interest margin ratio <sup>(1)(2)</sup> | 4.16  | 4.12  | 3.99  | 3.89  | 3.95  |
| Earnings to fixed charges:                  |       |       |       |       |       |
| Excluding interest on deposits              | 2.51x | 2.43x | 1.58x | 1.63x | 2.26x |
| Including interest on deposits              | 1.70  | 1.55  | 1.18  | 1.17  | 1.34  |

|   |       |       |       |       |        |
|---|-------|-------|-------|-------|--------|
| <b>ASSET QUALITY RATIOS</b>   |       |       |       |       |        |
| Nonperforming assets to total assets                                  | 2.39% | 3.07% | 2.71% | 2.51% | 1.06%  |
| Nonperforming loans and leases to total loans and leases              | 2.31  | 3.87  | 3.35  | 3.24  | 1.40   |
| Net loan and lease charge-offs to average loans and leases            | 1.46  | 1.31  | 1.38  | 1.15  | 0.30   |
| Allowance for loan and lease losses to total loans and leases         | 1.48  | 1.82  | 1.80  | 1.48  | 1.45   |
| Allowance for loan and lease losses to nonperforming loans and leases | 64.09 | 47.12 | 53.56 | 45.73 | 103.66 |

|   |       |       |       |       |       |
|---|-------|-------|-------|-------|-------|
| <b>CONSOLIDATED CAPITAL RATIOS</b>      |       |       |       |       |       |
| Average equity to average assets        | 8.47% | 8.13% | 8.4%  | 6.88% | 6.84% |
| Average common equity to average assets | 6.45  | 6.13  | 6.32  | 6.80  | 6.84  |
| Total capital to risk-adjusted assets   | 15.87 | 16.23 | 15.20 | 14.92 | 12.48 |
| Tier 1 leverage                         | 14.08 | 14.06 | 13.53 | 10.68 | 8.01  |

(1) Excludes the discontinued operations of our Broadus branch and the related gain on sale in 2007.

(2) Tax equivalent using a 35% tax rate.

\* The selected historical consolidated financial information set forth above is qualified in its entirety by reference to, and should be read in conjunction with, Heartland's consolidated financial statements and notes thereto, included elsewhere in this report and Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations."

## **ITEM 7.**

### **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following presents management's discussion and analysis of the consolidated financial condition and results of operations of Heartland as of the dates and for the periods indicated. This discussion should be read in conjunction with the Selected Financial Data, Heartland's Consolidated Financial Statements and the Notes thereto and other financial data appearing elsewhere in this report. The Consolidated Financial Statements include the accounts of Heartland and its subsidiaries. All of Heartland's subsidiaries are wholly-owned except for Minnesota Bank & Trust, of which Heartland is an 80% owner.

#### **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 this Form 10-K. 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 preparation of financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, income and expenses. These estimates are based upon historical experience and on various other assumptions that management believes are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The estimates and judgments that management believes have the most effect on Heartland's reported financial position and results of operations are as follows:

##### **Allowance For Loan And Lease Losses**

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. For loans individually evaluated and determined to be impaired, the allowance is allocated on a loan-by-loan basis as deemed necessary. These estimates reflect consideration of one of three impairment measurement methods as of the evaluation date: (1) the present value of expected future cash flows discounted at the loan's effective interest rate; (2) the loan's observable market price; or (3) the fair value of the collateral if the loan is collateral dependent. All other loans, including individually evaluated loans determined not to be impaired, are segmented into groups of loans with similar risk characteristics for evaluation and analysis. Loss rates for various collateral types of commercial and agricultural loans are established through assigned discount factors based upon the realizable value historically received on the various types of collateral. For smaller commercial and agricultural loans, residential real estate loans and consumer loans, a historic loss rate is established for each group of loans based upon a twelve-quarter weighted moving average loss rate. 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 boards of directors of each Bank Subsidiary.

Specific factors considered by management in establishing the allowance included the following:

- Heartland has experienced an increase in net charge-offs during the past four years.
- During the last several years, Heartland has entered new geographical markets in which it had little or no previous lending experience.
- Heartland has continued to experience growth in more complex commercial loans as compared to relatively lower-risk residential real estate loans.

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 December 31, 2011. 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 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 us to make additional provisions to the allowance based upon their judgment about information available to them at the time of their examinations.

During the first quarter of 2010, we implemented a new methodology, including the installation of new software, for the calculation of the allowance for loan and lease losses. The implementation of this new methodology included the establishment of a dual risk rating system, which allows the utilization of a probability of default and loss given default for commercial and agricultural loans in the calculation of the allowance for loan lease losses. In addition to an enhanced allowance methodology, this software also has the ability to perform stress testing and migration analysis on various portfolio segments.

The table below estimates the theoretical range of the 2011 allowance outcomes and related changes in provision expense assuming either a reasonably possible deterioration in loan credit quality or a reasonably possible improvement in loan credit quality:

#### **THEORETICAL RANGE OF ALLOWANCE FOR LOAN AND LEASE LOSSES**

(Dollars in thousands)

|  |                  |
|--|------------------|
| Allowance for loan and lease losses at December 31, 2011 | <u>\$ 36,808</u> |
| Assuming deterioration in credit quality:                |                  |
| Addition to provision                                    | 1,638            |
| Resultant allowance for loan and lease losses            | <u>\$ 38,446</u> |
| Assuming improvement in credit quality:                  |                  |
| Reduction in provision                                   | (1,851)          |
| Resultant allowance for loan and lease losses            | <u>\$ 34,957</u> |

The assumptions underlying this sensitivity analysis represent an attempt to quantify theoretical changes that could occur in the total allowance for loan and lease losses given various economic assumptions that could impact inherent loss in the current loan and lease portfolio. It further assumes that the general composition of the allowance for loans and lease losses determined through our existing process and methodology remains relatively unchanged. It does not attempt to encompass extreme and/or prolonged economic downturns, systemic contractions to specific industries, or systemic shocks to the financial services sector. The addition to provision was calculated based upon the assumption that, under an economic downturn, the qualitative portion of the calculated allowance will increase due to increase in qualitative risk factors directly affected by the economic conditions. The reduction in provision was calculated based upon the assumption that, under an economic upturn, the qualitative portion of the calculated allowance will decrease due to decrease in qualitative risk factors directly affected by the economic conditions.

#### **Goodwill And Other Intangibles**

We record all assets and liabilities acquired in purchase acquisitions, including goodwill and other intangibles, at fair value. Goodwill and indefinite-lived assets are not amortized but are subject, at a minimum, to annual tests for impairment. In certain situations, interim impairment tests may be required if events occur or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. Other intangible assets are amortized over their estimated useful lives using straight-line and accelerated methods and are subject to impairment if events or circumstances indicate a possible inability to realize the carrying amount.



The initial recognition of goodwill and other intangible assets and subsequent impairment analysis require us to make subjective judgments concerning estimates of how the acquired assets will perform in the future using valuation methods including discounted cash flow analysis. Additionally, estimated cash flows may extend beyond five years and, by their nature, are difficult to determine over an extended timeframe. Events and factors that may significantly affect the estimates include, among others, competitive forces, customer behaviors, changes in revenue growth trends, cost structures, technology, changes in discount rates and market conditions. In determining the reasonableness of cash flow estimates, Heartland reviews historical performance of the underlying assets or similar assets in an effort to assess and validate assumptions utilized in its estimates.

In assessing the fair value of reporting units, we may consider the stage of the current business cycle and potential changes in market conditions in estimating the timing and extent of future cash flows. Also, we often utilize other information to validate the reasonableness of its valuations including public market comparables, and multiples of recent mergers and acquisitions of similar businesses. Valuation multiples may be based on revenue, price-to-earnings and tangible capital ratios of comparable companies and business segments. These multiples may be adjusted to consider competitive differences, including size, operating leverage and other factors. The carrying amount of a reporting unit is determined based on the capital required to support the reporting unit's activities, including its tangible and intangible assets. The determination of a reporting unit's capital allocation requires judgment and considers many factors, including the regulatory capital regulations and capital characteristics of comparable companies in relevant industry sectors. In certain circumstances, we will engage a third-party to independently validate its assessment of the fair value of its reporting units.

We assess the impairment of identifiable intangible assets, long lived assets and related goodwill whenever events or changes in circumstances indicate the carrying value may not be recoverable. Factors considered important, which could trigger an impairment review include the following:

- Significant under-performance relative to expected historical or projected future operating results.
- Significant changes in the manner of use of the acquired assets or the strategy for the overall business.
- Significant negative industry or economic trends.
- Significant decline in the market price for our common stock over a sustained period; and market capitalization relative to net book value.
- For intangible assets and long-lived assets, if the carrying value of the asset exceeds the undiscounted cash flows from such asset.

We engaged a third-party valuation consultant to determine the fair value of goodwill recorded in connection with two of our Bank Subsidiaries at the end of 2009. Based on this valuation, we determined that the fair value of the goodwill associated with these two subsidiaries was less than the carrying amount previously used for this goodwill and that the goodwill was impaired. Accordingly, we recorded an impairment charge of \$12.7 million in the fourth quarter of 2009 to reduce the carrying value to fair value at Arizona Bank & Trust and Rocky Mountain Bank. During the third quarter of 2010, a calculation error was discovered in the valuation performed by the independent third party consultant and resulted in the recording of an additional goodwill impairment charge totaling \$1.6 million at Rocky Mountain Bank. After consideration of both quantitative and qualitative factors, we determined the amount was not material to the financial statements for 2009 and thus recorded such amount in the third quarter of 2010. A different third party consultant was engaged during the fourth quarter of 2010 to perform another valuation of the remaining goodwill recorded at Rocky Mountain Bank. Based upon the updated valuation, we determined that no further goodwill impairment charges were required. Heartland conducted an internal assessment of the goodwill both collectively and at its subsidiaries in 2011 and determined no further goodwill impairment charges were required.

## OVERVIEW

Heartland is a diversified financial services holding company providing full-service community banking through nine banking subsidiaries with a total of 61 banking locations in Iowa, Illinois, Wisconsin, New Mexico, Arizona, Montana, Colorado and Minnesota. In addition, Heartland has separate subsidiaries in the consumer finance, insurance and property management businesses. Our primary strategy is to balance our focus on increasing profitability with asset growth and diversification through acquisitions, *de novo* bank formations and branch openings within existing market areas.

Our 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, loan servicing income, trust income, brokerage and insurance commissions, securities gains and gains on sale of loans, also affects our results of operations. Our principal operating expenses, aside from interest expense, consist of salaries and employee benefits, occupancy and equipment costs, professional fees, FDIC insurance premiums and the provision for loan and lease

losses. During the most recent years, our operating expenses have also been significantly impacted by net losses on repossessed assets.

Net income recorded for 2011 was \$28.0 million, compared to \$23.8 million recorded during 2010, an increase of \$4.2 million or 18%. Net income available to common stockholders was \$20.4 million, or \$1.23 per diluted common share, for 2011, compared to \$18.6 million, or \$1.13 per diluted common share, earned during 2010. Return on average common equity was 7.77% and return on average assets was 0.50% for 2011, compared to 7.51% and 0.46%, respectively, for 2010.

Earnings for 2011 in comparison to 2010 were positively affected by increases in securities gains, which were \$13.1 million during 2011 compared to \$6.8 million during 2010, gains on sale of loans, which were \$11.4 million during 2011 compared to \$8.1 million during 2010, and net interest income, which was \$145.4 million during 2011 compared to \$143.1 million during 2010. Also positively affecting net income for 2011 were reductions in provision for loan losses, which were \$29.4 million in 2011 compared to \$32.5 million in 2010, net losses on repossessed assets, which were \$9.8 million during 2011 compared to \$15.3 million during 2010, and FDIC insurance assessments, which were \$3.8 million during 2011 compared to \$5.4 million during 2010. Net interest margin, expressed as a percentage of average earning assets, was 4.16% during 2011 compared to 4.12% during 2010. The effect of these positive factors was offset somewhat by a decrease in loan servicing income, which was \$5.9 million during 2011 compared to \$7.2 million during 2010, an increase in salaries and employee benefits, which totaled \$75.5 million during 2011 compared to \$63.4 million during 2010, an increase in professional fees, which totaled \$12.6 million during 2011 compared to \$10.4 million during 2010, and an increase in other noninterest expenses, which totaled \$15.7 million during 2011 compared to \$13.4 million during 2010.

Net income for 2010 was \$23.8 million, compared to \$6.4 million in 2009, an increase of \$17.4 million or 272%. Net income available to common stockholders was \$18.6 million, or \$1.13 per diluted common share, for 2010, compared to \$1.2 million, or \$0.07 per diluted common share, earned during 2009. Return on average common equity was 7.51% and return on average assets was 0.46% for 2010, compared to 0.51% and 0.03%, respectively, for 2009.

Excluding a goodwill impairment charge of \$1.6 million, net income for 2010 would have been \$25.4 million, net income available to common stockholders would have been \$20.2 million, or \$1.23 per diluted common share, return on average common equity would have been 8.17% and return on average assets would have been 0.50%. Excluding the goodwill impairment charge of \$12.7 million recorded during the fourth quarter of 2009, net income for 2009 would have been \$19.0 million, net income available to common stockholders would have been \$13.9 million, or \$0.85 per diluted common share, return on average common equity would have been 5.76% and return on average assets would have been 0.36%. The goodwill impairment charges, which are non-cash charges that have no impact on operations, liquidity or capital, were due to the adverse economic conditions in our Arizona and Montana markets. Exclusive of the goodwill impairment charges, net income for 2010 increased \$6.4 million or 34% over 2009.

Earnings for 2010 in comparison to 2009 were positively affected by increased net interest income, which increased \$10.3 million or 8% over the prior year. Net interest margin, expressed as a percentage of average earning assets, was 4.12% during 2010 compared to 3.99% during 2009. Also positively affecting net income for 2010 was a \$6.9 million or 17% reduction in provision for loan losses, which was \$32.5 million in 2010 compared to \$39.4 million in 2009. Noninterest income remained relatively flat at \$52.3 million during 2010 compared to \$52.7 million in 2009. The categories of noninterest income experiencing increases during 2010 as compared to 2009 were service charges and fees, which increased \$1.4 million or 11%, trust fees, which increased \$1.4 million or 18%, and gains on sale of loans, which increased \$2.0 million or 33%. The effect of these positive factors was offset somewhat by decreases in loan servicing income, which decreased \$2.4 million or 25%, and gains on sales of securities, which was \$6.8 million in 2010 compared to \$8.6 million in 2009. Total noninterest expense, exclusive of goodwill impairment charges, increased \$7.7 million or 6%. The most significant contributors to this increase were salaries and employee benefits, which increased \$2.9 million or 5%, professional fees, which increased \$1.3 million or 14%, and net losses on repossessed assets, which totaled \$15.3 million in 2010 compared to \$10.8 million in 2009. The effect of these increases was partially mitigated by a \$1.1 million or 17% reduction in FDIC insurance assessments.

At December 31, 2011, total assets were \$4.31 billion, an increase of \$305.6 million or 8%, over total assets of \$4.00 billion at December 31, 2010. Securities represented 31% of total assets at year-end 2011 compared to 32% at year-end 2010. Total loans and leases, exclusive of those covered by loss share agreements, were \$2.48 billion at December 31, 2011, compared to \$2.34 billion at year-end 2010, an increase of \$137.3 million or 6%. Commercial and commercial real estate loans, which totaled \$1.81 billion at December 31, 2011, increased \$90.5 million or 5% since year-end 2010. Residential mortgage loans, which totaled \$194.4 million at December 31, 2011, increased \$30.7 million or 19% since year-end 2010. Agricultural and agricultural real estate loans, which totaled \$263.0 million at December 31, 2011, increased \$12.0 million or 5% since year-end 2010. Consumer loans, which totaled \$220.1 million at December 30, 2011, increased \$5.6 million or 3% since year-end 2010. Total deposits were \$3.21 billion at December 31, 2011, compared to \$3.03 billion at year-end 2010, an increase of \$176.1 million or

6%. The composition of Heartland's deposits shifted from higher cost certificates of deposit to no cost demand deposits during 2011, as demand deposits increased \$156.7 million or 27% since year-end 2010. Certificates of deposit, exclusive of brokered deposits, experienced a decrease of \$103.8 million or 12% since year-end 2010. At December 31, 2011, brokered time deposits totaled \$41.2 million or 1% of total deposits compared to \$37.3 million or 1% of total deposits at December 31, 2010.

At December 31, 2010, total assets had experienced a slight decrease of \$13.5 million or less than 1% since December 31, 2009. Securities represented 32% of total assets at December 31, 2010, compared to 29% of total assets at December 31, 2009. Total loans and leases receivable, exclusive of those covered by loss share agreements, were \$2.34 billion at December 31, 2010, compared to \$2.33 billion at year-end 2009, an increase of \$12.8 million or 1%. The loan category experiencing the majority of the growth during 2010 was commercial and commercial real estate loans, which totaled \$1.72 billion at December 31, 2010, an increase of \$48.9 million or 3% since year-end 2009. This growth occurred at Dubuque Bank and Trust Company, Wisconsin Community Bank, New Mexico Bank & Trust and Minnesota Bank & Trust. Total deposits were \$3.03 billion at December 31, 2010, compared to \$3.05 billion at December 31, 2009, a decrease of \$16.3 million or 1%. The composition of Heartland's deposits improved during 2010, as demand deposits increased \$119.9 million or 26%. Savings deposits grew \$4.6 million or less than 1% since December 31, 2009. Time deposits, exclusive of brokered deposits, experienced a decrease of \$136.4 million or 14% during 2010. At December 31, 2010, brokered time deposits totaled \$37.3 million or 1% of total deposits compared to \$41.8 million or 1% of total deposits at December 31, 2009.

On September 15, 2011, Heartland joined the Small Business Lending Fund ("SBLF"). Simultaneous with receipt of the SBLF funds, Heartland redeemed the \$81.7 million of preferred stock issued to the U.S. Treasury in December 2008 under the Capital Purchase Program, a part of the Troubled Asset Relief Program ("TARP"). As a result of this redemption, \$2.6 million in remaining unamortized discount on preferred stock was recognized during the third quarter of 2011. Exclusive of this one-time event, net income available to common stockholders for 2011 would have been \$23.0 million or \$1.39 per diluted common share.

On June 10, 2011, Heartland completed the charter consolidation of its First Community Bank subsidiary located in Keokuk, Iowa, with its flagship subsidiary bank, Dubuque Bank and Trust Company, located in Dubuque, Iowa. Through this charter consolidation, Heartland hopes to realize efficiencies in operating costs, audit fees, regulatory examinations and insurance premiums.

## **RESULTS OF OPERATIONS**

### **Net Interest Income**

Net interest income is the difference between interest income earned on earning assets and interest expense paid on interest bearing liabilities. As such, net interest income is affected by changes in the volume and yields on earning assets and the volume and rates paid on interest bearing liabilities. Net interest margin is the ratio of tax equivalent net interest income to average earning assets.

Net interest margin, expressed as a percentage of average earning assets, was 4.16% during 2011 compared to 4.12% during 2010 and 3.99% during 2009. The continuation of a net interest margin above 4.00% has been a direct result of Heartland's pricing discipline. Also positively affecting net interest margin during 2011 was improvement in the level of nonaccrual loans not covered by loss share agreements, which had balances of \$57.4 million or 2.31% of total loans and leases at December 31, 2011, compared to \$90.6 million or 3.87% of total loans and leases at December 31, 2010, and \$78.1 million or 3.35% of total loans and leases at December 31, 2009. Because deposit rates have been set at close to the bottom of their manageable range, and because the reinvestment rates on maturing securities have fallen dramatically and loan rates are presently impacted by competition for new loans, management anticipates that it will be increasingly difficult to maintain net interest margin above 4.00% during the coming year.

On a tax-equivalent basis, interest income decreased \$6.2 million or 3% to \$197.7 million during 2011 compared to \$203.9 million during 2010. The positive effect of a \$44.2 million or 1% growth in average earning assets during 2011 compared to 2010 on interest income, was more than offset by the impact of a decrease in the average interest rate earned on these assets which was 5.43% during 2011 compared to 5.67% during 2010, primarily due to the decrease in the average interest rate earned on total securities which was 3.69% during 2011 compared to 4.17% during 2010. The composition of average earning assets changed as the percentage of average loans, which are typically the highest yielding asset, to total average earning assets was 65% during 2011 compared to 66% during 2010. On a tax-equivalent basis, interest income decreased \$3.9 million or 2% to \$203.9 million during 2010 compared to \$207.8 million during 2009. Growth in average earning assets during 2010 was \$157.7 million or 5% over 2009. The percentage of average loans to total average earning assets was 66% during 2010 compared to 69% during 2009.

Interest expense for 2011 was \$46.3 million compared to \$55.9 million during 2010, a decrease of \$9.6 million or 17%. During 2010, interest expense decreased \$14.6 million or 21% from \$70.5 million paid during 2009. Interest rates paid on our deposits and borrowings decreased significantly during 2011 and 2010. These decreases resulted primarily from an outflow of higher cost certificates of deposit and a reduction in other borrowings. The average interest rates paid on Heartland's interest bearing deposits and borrowings was 1.53% in 2011 compared to from 1.79% in 2010 and 2.34% in 2009. The opportunity for continued downward repricing of maturing certificates of deposit has begun to diminish. For the next twelve months, the amount of certificates of deposit maturing is \$347.0 million, or 44% of total certificates of deposit, at a weighted average rate of 1.41%. Additionally, we believe that the rates currently paid on our non-maturity deposits are effectively approaching a floor and that we will have less flexibility to pay lower rates on these deposits in the future.

Net interest income on a tax-equivalent basis increased \$3.3 million or 2% during 2011 and \$10.7 million or 8% during 2010. These increases reflect Heartland's success in optimizing the composition of its interest bearing liabilities by de-emphasizing higher cost time deposits, which decreased to 35% of total average interest bearing deposits during 2011 compared to 38% during 2010 and 47% during 2009.

We attempt to manage our balance sheet to minimize the effect that a change in interest rates has on our net interest margin. We plan to continue to work toward improving both our earning asset and funding mix through targeted organic growth strategies, which we believe will result in additional net interest income. We believe our 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. Approximately 40% of our commercial and agricultural loan portfolios consist of floating rate loans that reprice immediately upon a change in the national prime interest rate. Since a large portion of these floating rate loans have interest rate floors that are currently in effect, an upward movement in the national prime interest rate would not have an immediate positive affect on our interest income. Item 7A of this Form 10-K contains additional information about the results of our most recent net interest income simulations. Note 11 to the consolidated financial statements contains a detailed discussion of the derivative instruments we have utilized to manage interest rate risk.

The table below sets forth certain information relating to our average consolidated balance sheets and reflects the yield on average earning assets and the cost of average interest bearing liabilities for the years 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, and nonaccrual loans are included in each respective loan category. Interest income is measured on a tax equivalent basis using a 35% tax rate.

# ANALYSIS OF AVERAGE BALANCES, TAX EQUIVALENT YIELDS AND RATES<sup>(1)</sup>

(Dollars in thousands)

|   | For the year ended Dec. 31, 2011 |            |       | For the year ended Dec. 31, 2010 |            |       | For the year ended Dec. 31, 2009 |            |       |
|---|----------------------------------|------------|-------|----------------------------------|------------|-------|----------------------------------|------------|-------|
|   | Average Balance                  | Interest   | Rate  | Average Balance                  | Interest   | Rate  | Average Balance                  | Interest   | Rate  |
| <b>EARNING ASSETS</b>                                       |                                  |            |       |                                  |            |       |                                  |            |       |
| Securities:   |                                  |            |       |                                  |            |       |                                  |            |       |
| Taxable   | \$ 959,953                       | \$ 28,195  | 2.94% | \$ 956,976                       | \$ 34,507  | 3.61% | \$ 873,276                       | \$ 39,782  | 4.56% |
| Municipals <sup>(1)(2)</sup>                                | 300,193                          | 18,262     | 6.08  | 264,307                          | 16,408     | 6.21  | 186,716                          | 12,307     | 6.59  |
| Total securities  | 1,260,146                        | 46,457     | 3.69  | 1,221,283                        | 50,915     | 4.17  | 1,059,992                        | 52,089     | 4.91  |
| Interest bearing deposits                                   | 3,179                            | 3          | 0.09  | 3,541                            | 14         | 0.40  | 2,943                            | 27         | 0.92  |
| Federal funds sold  | 430                              | 1          | 0.23  | 667                              | 1          | 0.15  | 835                              | 2          | 0.24  |
| Loans and leases:   |                                  |            |       |                                  |            |       |                                  |            |       |
| Commercial and commercial real estate <sup>(1)(3)</sup>     | 1,747,968                        | 99,986     | 5.72  | 1,727,548                        | 101,720    | 5.89  | 1,696,794                        | 101,854    | 6.00  |
| Residential real estate                                     | 198,312                          | 10,172     | 5.13  | 203,596                          | 10,663     | 5.24  | 219,303                          | 12,596     | 5.74  |
| Agricultural and agricultural real estate <sup>(1)(3)</sup> | 255,615                          | 15,553     | 6.08  | 258,943                          | 15,966     | 6.17  | 259,700                          | 16,633     | 6.40  |
| Consumer  | 216,268                          | 20,526     | 9.49  | 224,288                          | 20,052     | 8.94  | 232,475                          | 20,325     | 8.74  |
| Direct financing leases, net                                | 701                              | 38         | 5.42  | 1,572                            | 92         | 5.85  | 3,927                            | 213        | 5.42  |
| Fees on loans   | —                                | 4,939      | —     | —                                | 4,452      | —     | —                                | 4,085      | —     |
| Less: allowance for loan and lease losses                   | (42,693)                         | —          | —     | (45,748)                         | —          | —     | (37,964)                         | —          | —     |
| Net loans and leases  | 2,376,171                        | 151,214    | 6.36  | 2,370,199                        | 152,945    | 6.45  | 2,374,235                        | 155,706    | 6.56  |
| Total earning assets  | 3,639,926                        | \$ 197,675 | 5.43% | 3,595,690                        | \$ 203,875 | 5.67% | 3,438,005                        | \$ 207,824 | 6.04% |
| <b>NONEARNING ASSETS</b>                                    |                                  |            |       |                                  |            |       |                                  |            |       |
| Total nonearning assets                                     | 431,885                          |            |       | 434,692                          |            |       | 374,738                          |            |       |
| <b>TOTAL ASSETS</b>   | <b>\$ 4,071,811</b>              |            |       | <b>\$ 4,030,382</b>              |            |       | <b>\$ 3,812,743</b>              |            |       |
| <b>INTEREST BEARING LIABILITIES</b>                         |                                  |            |       |                                  |            |       |                                  |            |       |
| Interest bearing deposits:                                  |                                  |            |       |                                  |            |       |                                  |            |       |
| Savings   | \$ 1,589,697                     | \$ 9,090   | 0.57% | \$ 1,557,658                     | \$ 13,677  | 0.88% | \$ 1,282,212                     | \$ 18,407  | 1.44% |
| Time, \$100,000 and over                                    | 265,664                          | 5,928      | 2.23  | 296,325                          | 7,534      | 2.54  | 373,159                          | 11,202     | 3.00  |
| Other time deposits   | 590,767                          | 14,206     | 2.40  | 649,892                          | 17,061     | 2.63  | 754,814                          | 23,135     | 3.06  |
| Short-term borrowings                                       | 202,183                          | 893        | 0.44  | 200,389                          | 1,160      | 0.58  | 143,239                          | 733        | 0.51  |
| Other borrowings  | 373,119                          | 16,226     | 4.35  | 423,125                          | 16,448     | 3.89  | 464,816                          | 17,053     | 3.67  |
| Total interest bearing liabilities                          | 3,021,430                        | 46,343     | 1.53  | 3,127,389                        | 55,880     | 1.79  | 3,018,240                        | 70,530     | 2.34  |
| <b>NONINTEREST BEARING LIABILITIES</b>                      |                                  |            |       |                                  |            |       |                                  |            |       |
| Noninterest bearing deposits                                | 667,952                          |            |       | 536,053                          |            |       | 437,468                          |            |       |
| Accrued interest and other liabilities                      | 37,551                           |            |       | 39,363                           |            |       | 36,700                           |            |       |
| Total noninterest bearing liabilities                       | 705,503                          |            |       | 575,416                          |            |       | 474,168                          |            |       |
| <b>STOCKHOLDERS' EQUITY</b>                                 | <b>344,878</b>                   |            |       | <b>327,577</b>                   |            |       | <b>320,335</b>                   |            |       |
| <b>TOTAL LIABILITIES &amp; STOCKHOLDERS' EQUITY</b>         | <b>\$ 4,071,811</b>              |            |       | <b>\$ 4,030,382</b>              |            |       | <b>\$ 3,812,743</b>              |            |       |
| Net interest income <sup>(1)</sup>                          |                                  | \$ 151,332 |       |                                  | \$ 147,995 |       |                                  | \$ 137,294 |       |
| Net interest spread   |                                  |            | 3.90% |                                  |            | 3.88% |                                  |            | 3.70% |
| Net interest income to total earning assets <sup>(1)</sup>  |                                  |            | 4.16% |                                  |            | 4.12% |                                  |            | 3.99% |
| Interest bearing liabilities to earning assets              | 83.01%                           |            |       | 86.98%                           |            |       | 87.79%                           |            |       |

(1) Tax equivalent basis is calculated using an effective tax rate of 35%.

(2) Includes taxable municipal securities of \$109.8 million, \$101.2 million and \$31.9 million for 2011, 2010 and 2009, respectively.

(3) Nonaccrual loans are included in average loans outstanding.

The following table presents the dollar amount of changes in interest income and interest expense for the major components of interest earning assets and interest bearing liabilities. It quantifies the changes in interest income and interest expense related to changes in the average outstanding balances (volume) and those changes caused by fluctuating interest rates. For each category of interest earning assets and interest bearing liabilities, information is provided on changes attributable to (i) changes in volume, calculated by multiplying the difference between the average balance for the current period and the average balance for the prior period by the rate for the prior period, and (ii) changes in rate, calculated by multiplying the difference between the rate for the current period and the rate for the prior period by the average balance for the prior period. The unallocated change has been allocated pro rata to volume and rate variances.

## ANALYSIS OF CHANGES IN NET INTEREST INCOME<sup>(1)</sup>

(Dollars in thousands)

|   | For the years ended December 31, |                 |                 |                       |                 |                  |
|---|----------------------------------|-----------------|-----------------|-----------------------|-----------------|------------------|
|   | 2011 Compared to 2010            |                 |                 | 2010 Compared to 2009 |                 |                  |
|   | Change Due to                    |                 |                 | Change Due to         |                 |                  |
|   | Volume                           | Rate            | Net             | Volume                | Rate            | Net              |
| <b>EARNING ASSETS / INTEREST INCOME</b>   |                                  |                 |                 |                       |                 |                  |
| Investment securities:                    |                                  |                 |                 |                       |                 |                  |
| Taxable                                   | \$ 2,743                         | \$ (9,055)      | \$ (6,312)      | \$ 3,813              | \$ (9,088)      | \$ (5,275)       |
| Municipals <sup>(1)(2)</sup>              | (2,910)                          | 4,764           | 1,854           | 5,114                 | (1,013)         | 4,101            |
| Interest bearing deposits                 | (1)                              | (10)            | (11)            | 5                     | (18)            | (13)             |
| Federal funds sold                        | —                                | —               | —               | —                     | (1)             | (1)              |
| Loans and leases <sup>(1)(3)</sup>        | 385                              | (2,116)         | (1,731)         | (265)                 | (2,496)         | (2,761)          |
| <b>TOTAL EARNING ASSETS</b>               | 217                              | (6,417)         | (6,200)         | 8,667                 | (12,616)        | (3,949)          |
| <b>LIABILITIES / INTEREST EXPENSE</b>     |                                  |                 |                 |                       |                 |                  |
| Interest bearing deposits:                |                                  |                 |                 |                       |                 |                  |
| Savings                                   | 276                              | (4,863)         | (4,587)         | 3,954                 | (8,684)         | (4,730)          |
| Time, \$100,000 and over                  | (736)                            | (870)           | (1,606)         | (2,307)               | (1,361)         | (3,668)          |
| Other time deposits                       | (1,484)                          | (1,371)         | (2,855)         | (3,216)               | (2,858)         | (6,074)          |
| Short-term borrowings                     | 10                               | (277)           | (267)           | 292                   | 135             | 427              |
| Other borrowings                          | (2,059)                          | 1,837           | (222)           | (1,530)               | 925             | (605)            |
| <b>TOTAL INTEREST BEARING LIABILITIES</b> | (3,993)                          | (5,544)         | (9,537)         | (2,807)               | (11,843)        | (14,650)         |
| <b>NET INTEREST INCOME</b>                | <u>\$ 4,210</u>                  | <u>\$ (873)</u> | <u>\$ 3,337</u> | <u>\$ 11,474</u>      | <u>\$ (773)</u> | <u>\$ 10,701</u> |

(1) Tax equivalent basis is calculated using an effective tax rate of 35%.

(2) Includes taxable municipal securities of \$109.8 million, \$101.2 million and \$31.9 million for 2011, 2010 and 2009, respectively.

(3) Nonaccrual loans are included in average loans outstanding.

## Provision For Loan And Lease Losses

The allowance for loan and lease losses is established through a provision charged to expense to provide, in Heartland management's opinion, an adequate allowance for loan and lease losses. The adequacy of the allowance for loan and lease losses is determined by management 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, substandard credits and doubtful credits. For additional details on the specific factors considered, refer to the critical accounting policies and allowance for loan and lease losses sections of this report. We believe the allowance for loan and lease losses as of December 31, 2011, was at a level commensurate with the overall risk exposure of the loan portfolio. However, if economic conditions should become more unfavorable, certain 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.

The allowance for loan and lease losses at December 31, 2011, was 1.48% of loans and leases and 64.09% of nonperforming loans compared to 1.82% of loans and leases and 47.12% of nonperforming loans at December 31, 2010, and 1.80% of loans and leases and 53.56% of nonperforming loans at December 31, 2009. The provision for loan losses totaled \$29.4 million for

2011 compared to \$32.5 million for 2010 and \$39.4 million for 2009. Additions to the allowance for loan and lease losses began increasing with the recession in 2008 as depressed economic conditions resulted in increased delinquencies. Particularly affected were our Western markets in Arizona and Montana. The increased, although moderated, provisions continued during 2011 as some individual credits continued to be impacted and updated appraised values of collateral reflected a decline in property values due primarily to a lack of recent comparable sales and an extension of absorption periods.

## Noninterest Income

The table below shows our noninterest income for the years indicated:

### NONINTEREST INCOME

(Dollars in thousands)

|   | For the years ended December 31, |                  |                  | % Change      |               |
|---|----------------------------------|------------------|------------------|---------------|---------------|
|   | 2011                             | 2010             | 2009             | 2011/<br>2010 | 2010/<br>2009 |
| Service charges and fees, net                     | \$ 14,303                        | \$ 13,900        | \$ 12,541        | 3%            | 11 %          |
| Loan servicing income                             | 5,932                            | 7,232            | 9,666            | (18)          | (25)          |
| Trust fees  | 9,856                            | 9,206            | 7,773            | 7             | 18            |
| Brokerage and insurance commissions               | 3,511                            | 3,184            | 3,117            | 10            | 2             |
| Securities gains, net                             | 13,104                           | 6,834            | 8,648            | 92            | (21)          |
| Gain (loss) on trading account securities         | 89                               | (91)             | 211              | 198           | (143)         |
| Impairment loss on equity securities              | —                                | —                | (40)             | —             | (100)         |
| Gains on sale of loans held for sale              | 11,366                           | 8,088            | 6,084            | 41            | 33            |
| Income (loss) on bank-owned life insurance        | 1,349                            | 1,466            | 1,002            | (8)           | 46            |
| Gain on acquisition                               | —                                | —                | 1,296            | —             | (100)         |
| Valuation adjustment on mortgage servicing rights | (19)                             | —                | —                | —             | —             |
| Other noninterest income                          | 86                               | 2,510            | 2,406            | (97)          | 4             |
| Total noninterest income                          | <u>\$ 59,577</u>                 | <u>\$ 52,329</u> | <u>\$ 52,704</u> | <u>14%</u>    | <u>(1)%</u>   |

Noninterest income was \$59.6 million in 2011 compared to \$52.3 million in 2010, an increase of \$7.3 million or 14%. Categories contributing to the increase during 2011 compared to 2010 were securities gains, gains on sale of loans held for sale, service charges and fees, trust fees and brokerage and insurance commissions. Noninterest income was \$52.3 million during 2010 compared to \$52.7 million during 2009, a decrease of \$375,000 or 1%. Positively affecting noninterest income during 2010 were increases in service charges and fees, trust fees, gains on sale of loans held for sale and income on bank-owned life insurance. A portion of these increases were offset by decreases in loan servicing income and securities gains. Additionally, noninterest income during 2009 included a \$1.3 million gain on acquisition.

During 2011, service charges and fees increased \$403,000 or 3% from 2010 to 2011, and increased \$1.4 million or 11% from 2009 to 2010. Service charges on checking and savings accounts increased \$444,000 or 15% during 2011 to \$3.3 million and increased \$360,000 or 14% to \$2.9 million during 2010 from \$2.5 million during 2009. These fees were affected by increased service charges on commercial checking accounts as the earnings credit rate applied to the balances maintained in these accounts were at historically low levels and the resultant earnings credit was not sufficient to cover activity charges on these accounts. Overdraft fees totaled \$5.4 million during 2011, \$6.1 million during 2010 and \$5.9 million in 2009. The \$630,000 or 10% decrease in 2011 was primarily due to the implementation of the revisions to Regulation E that were effective August 15, 2010, and the impact of changes initiated to comply with FDIC guidance related to overdraft privilege programs. The Regulation E revisions had minimal impact during the last two quarters of 2010 as our Bank Subsidiaries were able to add 7,000 accounts to their overdraft protection service. Interchange revenue from activity on bank debit cards, along with surcharges on ATM activity, increased \$563,000 or 13% from \$4.4 million during 2010 to \$5.0 million during 2011, and increased \$836,000 or 23% from \$3.6 million during 2009 to \$4.4 million during 2010.

Loan servicing income decreased \$1.3 million or 18% during 2011 and \$2.4 million or 25% during 2010. Two components of loan servicing income, mortgage servicing rights and amortization of mortgage servicing rights, are dependent upon the level of loans Heartland originates and sells into the secondary market, which in turn is highly influenced by market interest rates for home mortgage loans. Mortgage servicing rights income was \$3.7 million during 2011 compared to \$5.8 million during 2010 and \$8.6 million during 2009. The amortization of mortgage servicing rights was \$3.6 million during 2011 compared to \$4.1



million during 2010 and \$3.6 million during 2009. Note 7 to the consolidated financial statements contains a discussion about our mortgage servicing rights. Long-term mortgage loan rates were at all-time lows during all of 2011 and much of 2010, which resulted in increased residential mortgage loan refinancing activity. Loan servicing income also includes the fees collected for the servicing of mortgage loans for others, which is dependent upon the aggregate outstanding balance of these loans, rather than quarterly production and sale of mortgage loans. Fees collected for the servicing of mortgage loans for others were \$3.6 million during 2011 compared to \$3.1 million during 2010 and \$2.4 million during 2009. The portfolio of mortgage loans serviced for others by Heartland totaled \$1.54 billion at December 31, 2011, compared to \$1.40 billion at December 31, 2010, and \$1.15 billion at December 31, 2009. We intend to continue to emphasize residential mortgage loan origination and expand this line of business during 2012.

Trust fees increased \$650,000 or 7% during 2011 and \$1.4 million or 18% during 2010. A large portion of trust fees are based upon the market value of the trust assets under management, which was \$1.36 billion at December 31, 2011, compared to \$1.38 billion at December 31, 2010, and \$1.16 billion at December 31, 2009. Those values fluctuate throughout the year as market conditions improve or decline. During 2010, market conditions had stabilized in comparison to 2009. The total number of trust accounts was 1,987 at December 31, 2011, compared to 1,970 at December 31, 2010, and 1,897 at December 31, 2009.

Brokerage and insurance commissions increased \$327,000 or 10% during 2011 and \$67,000 or 2% during 2010. During 2011, Heartland's customers continued to seek the higher rates offered in fixed income products and also overcame some of their reluctance to invest in equity securities. Consistent with the national market, these commissions were low in 2009 as clients were uncertain about the condition of the financial markets and unwilling to make investments that could result in further losses in their portfolios.

Securities gains totaled \$13.1 million during 2011 compared to \$6.8 million during 2010 and \$8.6 million during 2009. Volatility in the bond market provided opportunities in both 2011 and 2010 to swap securities from one sector of the portfolio to another without significantly changing the duration of the portfolio. One such strategy was the sale of taxable municipal bonds and the reinvestment into tax-exempt municipal bonds in 2011. Another strategy initiated in the second quarter of 2011 shifted a portion of the securities portfolio from agencies to treasuries and shorter-term mortgage-backed securities. Additionally, during the first quarter of 2011, a private label Z tranche security with a book value of \$10,000 was sold at a gain of \$1.4 million. Seven of these Z tranche securities remain in Heartland's securities available for sale portfolio at a book value of \$141,000 and a market value of \$3.1 million at December 31, 2011. Management has not determined when any future sales of these securities will occur.

The equity securities trading portfolio recorded gains of \$89,000 during 2011 compared to losses of \$91,000 during 2010 and gains of \$211,000 during 2009. The gains and losses recorded on this portfolio were generally reflective of the overall activity in the stock market.

Gains on sale of loans held for sale totaled \$11.4 million during 2011 compared to \$8.1 million during 2010, an increase of \$3.3 million or 41%. Even though the origination of 15- and 30-year, fixed-rate residential mortgage loans was slower during the first half of 2011 compared to the first half of 2010, the gains on sale of loans increased as a result of better pricing received on the sale of these loans into the secondary market. Beginning in the second quarter of 2011, Heartland began selling a majority of these loans under a bulk delivery method instead of on an individual delivery method. Refinancing activity increased during the third quarter of 2011 as long-term mortgage loan rates again fell to all-time lows, combined with the recent opening of loan production offices, operating under the National Residential Mortgage name, in metro San Diego, California; Austin, Texas; and Reno, Nevada. New residential mortgage loans are originated under the Heartland subsidiary bank brands in current banking markets or under the National Residential Mortgage brand in non-footprint locations. A team of mortgage banking professionals and executives in the Phoenix, Arizona market were hired by Heartland in late 2010. This unit has implemented a highly efficient loan origination process at all Heartland locations. As this unit expands both within and outside the Heartland footprint, management expects to see continued increases in mortgage loan originations from both new purchases and refinancing activity. Gains on sale of loans held for sale totaled \$8.1 million during 2010 compared to \$6.1 million during 2009, an increase of \$2.0 million or 33%. These gains increased during 2010 compared to 2009 as long-term mortgage loan rates fell to historical lows during the last half of 2010 and resulted in increased refinancing activity on 15- and 30-year, fixed-rate mortgage loans which we normally elect to sell into the secondary market and retain the servicing. During 2011, we originated \$537.8 million in new and refinanced loans to 2,830 borrowers as compared to \$694.3 million to 3,982 borrowers in 2010 and \$825.2 million to 4,560 borrowers in 2009. Even though the volume of these types of loans declined year to year, the gains on sale were sequentially higher as a result of more effective pricing on these loans.

Income on bank owned life insurance decreased \$117,000 or 8% during 2011 compared to 2010. A large portion of Heartland's bank owned life insurance is held in a separate account product that experienced lower yields during 2011. The change in cash surrender value on bank-owned life insurance resulted in income of \$1.5 million during 2010 compared to income of \$1.0 million during 2009, as the separate account product experienced improvement in market values during 2010.

Other noninterest income was \$86,000 during 2011 compared to \$2.5 million during 2010 and \$2.4 million during 2009. Affecting other noninterest income were payments due to or from the FDIC under loss share agreements associated with The Elizabeth State Bank acquisition completed on July 2, 2009. Payments due to the FDIC totaled \$913,000 during 2011, whereas payments due from the FDIC totaled \$652,000 during 2010 and \$1.1 million during 2009. During 2010, Heartland recorded other noninterest income for life insurance proceeds of \$502,000.

## Noninterest Expense

The table below shows our noninterest expense for the years indicated:

### NONINTEREST EXPENSE

(Dollars in thousands)

|                                 | For the years ended December 31, |                   |                   | % Change      |               |
|---------------------------------|----------------------------------|-------------------|-------------------|---------------|---------------|
|                                 | 2011                             | 2010              | 2009              | 2011/<br>2010 | 2010/<br>2009 |
| Salaries and employee benefits  | \$ 75,537                        | \$ 63,391         | \$ 60,465         | 19%           | 5 %           |
| Occupancy                       | 9,363                            | 9,121             | 8,992             | 3             | 1             |
| Furniture and equipment         | 5,636                            | 6,104             | 6,574             | (8)           | (7)           |
| Professional fees               | 12,567                           | 10,446            | 9,127             | 20            | 14            |
| FDIC insurance assessments      | 3,777                            | 5,441             | 6,578             | (31)          | (17)          |
| Advertising                     | 4,292                            | 3,830             | 3,337             | 12            | 15            |
| Goodwill impairment charge      | —                                | 1,639             | 12,659            | (100)         | (87)          |
| Intangible assets amortization  | 572                              | 591               | 866               | (3)           | (32)          |
| Net loss on repossessed assets  | 9,807                            | 15,264            | 10,847            | (36)          | 41            |
| Other noninterest expenses      | 15,745                           | 13,412            | 13,075            | 17            | 3             |
| Total noninterest expense       | <u>\$ 137,296</u>                | <u>\$ 129,239</u> | <u>\$ 132,520</u> | <u>6%</u>     | <u>(2)%</u>   |
| Efficiency ratio <sup>(1)</sup> | 69.41%                           | 66.79%            | 73.07%            |               |               |

(1) Noninterest expense divided by the sum of net interest income and noninterest income less security gains.

Noninterest expense totaled \$137.3 million in 2011 compared to \$129.2 million in 2010, an \$8.1 million or 6% increase. Contributing to this increase in noninterest expense were increases in salaries and employee benefits, professional fees and other noninterest expenses. The effect of these increases was partially mitigated by a decrease in FDIC insurance assessments and a decrease in net losses on repossessed assets. For 2010, noninterest expense decreased \$3.3 million or 2% when compared to 2009, primarily because of the impact of goodwill impairment charges which totaled \$1.6 million during 2010 and \$12.7 million during 2009. Exclusive of these goodwill impairment charges, noninterest expense increased \$7.7 million or 6% in 2010. The primary contributors to this increase were increases in salaries and employee benefits, professional fees and net losses on repossessed assets. The effect of these increases was partially mitigated by a decrease in FDIC insurance assessments.

The largest component of noninterest expense, salaries and employee benefits, increased \$12.1 million or 19% during 2011 compared to 2010, and increased \$2.9 million or 5% during 2010 compared to 2009. Most of the increase in 2011 and a portion of the increase in 2010 was a result of the expansion of residential loan origination and the addition of personnel in the Heartland Mortgage and National Residential Mortgage units. The increase in 2010 also reflects increased compensation rates as salaries that were frozen during the height of the recession were increased. Total average full-time equivalent employees were 1,114 during 2011 compared to 1,027 during 2010 and 1,024 during 2009.

Professional fees increased \$2.1 million or 20% during 2011 and \$1.3 million or 14% during 2010. These increases were primarily associated with the workout and disposition of nonperforming assets and the services provided to Heartland by third-party consultants.

FDIC assessments decreased \$1.7 million or 31% during 2011 and \$1.1 million or 17% during 2010, primarily associated with a change in the FDIC assessment rates that became effective April 1, 2011. These new rates are based upon total assets minus tangible equity of the insured bank instead of total deposits. Included in the FDIC assessments recorded during 2009 was \$1.7 million for the emergency special assessment.

Advertising expense was \$4.3 million during 2011 compared to \$3.8 million during 2010 and \$3.3 million during 2009. During 2010, we engaged a third party service provider to redesign the websites for our bank subsidiaries. In 2011, two additional websites were designed for significant product lines. Promotional expenses also increased commensurate with the development of our residential mortgage expansion, increased media advertising for retail checking accounts and television and radio production expense for a branding campaign.

Heartland's goodwill, which is related to acquisitions in prior years, is evaluated for impairment on an annual basis or when events or circumstances suggest impairment may have occurred. Due to the adverse economic conditions in our Arizona and Montana markets, we engaged an independent third party valuation expert to value the goodwill of those banks at the end of 2009. As a result of these valuations, we recorded a goodwill impairment charge of \$5.2 million at Arizona Bank & Trust and \$7.5 million at Rocky Mountain Bank in 2009. After the impairment charge was recorded, goodwill totaled \$27.5 million or less than 1% of total assets at December 31, 2009. An additional goodwill impairment charge of \$1.6 million was recorded at Rocky Mountain Bank during the third quarter of 2010. This amount represented the correction of a calculation error discovered during the third quarter of 2010 related to the impairment calculation in the valuation performed in 2009. After consideration of both quantitative and qualitative factors, we determined the amount was not material to the financial statements for 2009 and thus recorded such amount in the third quarter of 2010.

Net losses on repossessed assets totaled \$9.8 million during 2011 compared to \$15.3 million during 2010 and \$10.8 million during 2009. A majority of these losses resulted from valuation adjustments due to reductions in commercial real estate values.

Other noninterest expenses increased \$2.3 million or 17% during 2011. During the first quarter of 2011, a \$403,000 writedown on land in Phoenix, Arizona, which had originally been purchased for branch expansion but has now been listed for sale, was recorded. In addition, Heartland established a repurchase reserve for the potential buyback of residential mortgage loans totaling \$613,000 during the fourth quarter of 2011. The remaining increase in other noninterest expenses during 2011 resulted primarily from expenses associated with the ramp up of our mortgage origination operations.

## **Income Taxes**

Heartland's effective tax rate was 26.9% for 2011 compared to 29.2% for 2010 and 52.3% for 2009. Excluding a non-deductible goodwill impairment charge, our effective tax rate was 27.8% for 2010 and 27.2% for 2009. During the third quarter of 2011, Heartland's income taxes included a \$404,000 refund for state taxes attributable to the 2007 and 2008 tax years. The effective tax rate included federal low-income housing tax credits of \$798,000 in 2011, \$554,000 in 2010 and \$212,000 in 2009. The additional credits in 2011 and 2010 were associated with Dubuque Bank and Trust Company's ownership interest in a new low-income housing project for seniors located in Dubuque, Iowa. The effective tax rate is also affected by the level of tax-exempt interest income which, as a percentage of pre-tax income, was 28.8% during 2011, 27.3% during 2010 and 32.1% during 2009. The tax-equivalent adjustment for this tax-exempt interest income was \$5.9 million during 2011, \$4.9 million during 2010 and \$4.5 million during 2009.

## **FINANCIAL CONDITION**

At December 31, 2011, total assets had increased \$305.6 million or 8% since year-end 2010. Securities represented 31% of total assets at December 31, 2011, compared to 32% at December 31, 2010. At December 31, 2010, total assets had decreased \$13.5 million or less than 1% since year-end 2009. Securities represented 32% of total assets at December 31, 2010, compared to 29% at December 31, 2009. Additional securities were purchased during both 2011 and 2010 as deposit growth outpaced loan growth.

## Lending Activities

Heartland's major source of income is interest on loans and leases. The table below presents the composition of Heartland's loan and lease portfolio at the end of the years indicated:

### LOAN AND LEASE PORTFOLIO

(Dollars in thousands)

|  | As of December 31, |         |                    |         |                    |         |                    |         |                    |         |
|--|--------------------|---------|--------------------|---------|--------------------|---------|--------------------|---------|--------------------|---------|
|  | 2011               |         | 2010               |         | 2009               |         | 2008               |         | 2007               |         |
|  | Amount             | %       | Amount             | %       | Amount             | %       | Amount             | %       | Amount             | %       |
| <b>Loans and leases receivable held to maturity:</b>   |                    |         |                    |         |                    |         |                    |         |                    |         |
| Commercial   | \$ 645,666         | 25.95%  | \$ 558,031         | 23.75%  | \$ 420,021         | 17.98%  | \$ 434,444         | 18.03%  | \$ 400,788         | 17.55%  |
| Commercial real estate                                 | 1,163,784          | 46.79   | 1,160,962          | 49.43   | 1,250,087          | 53.52   | 1,283,627          | 53.27   | 1,231,809          | 53.93   |
| Residential real estate                                | 194,436            | 7.82    | 163,726            | 6.97    | 175,059            | 7.49    | 203,921            | 8.46    | 217,044            | 9.50    |
| Agricultural and agricultural real estate              | 262,975            | 10.57   | 250,943            | 10.68   | 256,780            | 10.99   | 247,664            | 10.28   | 225,663            | 9.88    |
| Consumer   | 220,099            | 8.85    | 214,515            | 9.13    | 231,709            | 9.92    | 234,061            | 9.72    | 199,518            | 8.74    |
| Lease financing, net                                   | 450                | 0.02    | 981                | 0.04    | 2,326              | 0.10    | 5,829              | 0.24    | 9,158              | 0.40    |
| Gross loans and leases receivable held to maturity     | 2,487,410          | 100.00% | 2,349,158          | 100.00% | 2,335,982          | 100.00% | 2,409,546          | 100.00% | 2,283,980          | 100.00% |
| Unearned discount                                      | (2,463)            |         | (2,581)            |         | (2,491)            |         | (2,443)            |         | (2,107)            |         |
| Deferred loan fees                                     | (3,663)            |         | (2,590)            |         | (2,349)            |         | (2,102)            |         | (1,706)            |         |
| Total net loans and leases receivable held to maturity | 2,481,284          |         | 2,343,987          |         | 2,331,142          |         | 2,405,001          |         | 2,280,167          |         |
| <b>Loans covered under loss share agreements:</b>      |                    |         |                    |         |                    |         |                    |         |                    |         |
| Commercial and commercial real estate                  | \$ 6,380           | 47.80%  | \$ 10,056          | 48.34%  | \$ 15,068          | 47.29%  | \$ —               | —%      | \$ —               | —%      |
| Residential mortgage                                   | 4,158              | 31.15   | 5,792              | 27.85   | 8,984              | 28.20   | —                  | —       | —                  | —       |
| Agricultural and agricultural real estate              | 1,659              | 12.43   | 2,723              | 13.09   | 3,626              | 11.38   | —                  | —       | —                  | —       |
| Consumer   | 1,150              | 8.62    | 2,229              | 10.72   | 4,182              | 13.13   | —                  | —       | —                  | —       |
| Total loans covered under loss share agreements        | 13,347             | 100.00% | 20,800             | 100.00% | 31,860             | 100.00% | —                  | —%      | —                  | —%      |
| Allowance for loan and lease losses                    | (36,808)           |         | (42,693)           |         | (41,848)           |         | (35,651)           |         | (32,993)           |         |
| Loans and leases receivable, net                       | <u>\$2,457,823</u> |         | <u>\$2,322,094</u> |         | <u>\$2,321,154</u> |         | <u>\$2,369,350</u> |         | <u>\$2,247,174</u> |         |

The table below sets forth the remaining maturities by loan and lease category, including loans held for sale and loans covered by loss share agreements, and excluding unearned discount and deferred loan fees, as of December 31, 2011:

**MATURITY AND RATE SENSITIVITY OF LOANS AND LEASES<sup>(1)</sup>**

(Dollars in thousands)

|   | Over 1 Year<br>Through 5 Years |                   |                   | Over 5 Years      |                   | Total               |
|---|--------------------------------|-------------------|-------------------|-------------------|-------------------|---------------------|
|   | One Year<br>or Less            | Fixed<br>Rate     | Floating<br>Rate  | Fixed<br>Rate     | Floating<br>Rate  |                     |
| Commercial                                | \$ 289,669                     | \$ 118,214        | \$ 81,932         | \$ 87,164         | \$ 71,311         | \$ 648,290          |
| Commercial real estate                    | 362,100                        | 381,493           | 237,994           | 43,774            | 142,179           | 1,167,540           |
| Residential real estate                   | 27,313                         | 36,521            | 13,302            | 111,468           | 62,425            | 251,029             |
| Agricultural and agricultural real estate | 128,530                        | 63,803            | 37,034            | 11,381            | 24,979            | 265,727             |
| Consumer                                  | 51,972                         | 63,151            | 8,755             | 13,385            | 83,986            | 221,249             |
| Lease financing, net                      | 297                            | 153               | —                 | —                 | —                 | 450                 |
| Total                                     | <u>\$ 859,881</u>              | <u>\$ 663,335</u> | <u>\$ 379,017</u> | <u>\$ 267,172</u> | <u>\$ 384,880</u> | <u>\$ 2,554,285</u> |

(1) Maturities based upon contractual dates

Total loans and leases, exclusive of those covered by loss share agreements, were \$2.48 billion at December 31, 2011, compared to \$2.34 billion at year-end 2010, an increase of \$137.3 million or 6%, with \$107.1 million occurring during the fourth quarter. The loan category experiencing the majority of the growth during 2011 was commercial and commercial real estate loans. During 2010, total loans and leases, exclusive of those covered by the FDIC loss share agreements, experienced an increase of \$12.8 million or 1%. The loan category experiencing the majority of the growth during 2010 was commercial and commercial real estate loans.

The commercial and commercial real estate loan category continues to be the primary focus for all the Bank Subsidiaries. These loans comprised 73% of the loan portfolio at both year-end 2011 and 2010 compared to 72% at year-end 2009. These loans increased \$90.5 million or 5% during 2011 compared to an increase of \$48.9 million or 3% during 2010. Nearly 65% of the 2011 growth occurred at our banks in the Midwest. The banks contributing most significantly to the 2011 growth were Dubuque Bank and Trust Company, Galena State Bank & Trust Co., Wisconsin Community Bank, Arizona Bank & Trust, Summit Bank & Trust and Minnesota Bank & Trust. Most of the 2010 growth occurred at Dubuque Bank and Trust Company, Wisconsin Community Bank, New Mexico Bank & Trust and Minnesota Bank & Trust.

The dividend rate payable on the preferred stock issued to the U.S. Treasury under the SBLF is subject to reduction during the second to tenth quarters after issuance (through December 31, 2013) based upon increases in qualified small business lending ("QSBL") over a baseline amount, and may be reduced to as low as 1.00% if QSBL increases by ten percent or more over that period. If Heartland's QSBL does not increase by the tenth quarter, the rate will increase to 7.00%. In addition, if there is no increase in our QSBL by January 1, 2014, we will be required to pay a special lending incentive fee of 2.00% per year through March 31, 2016. From the eleventh quarter through March 16, 2016, the rate remains fixed at the rate determined at the end of the tenth quarter and will increase to 9.00% if the SBLF funding has not been repaid by March 16, 2016. Heartland's baseline amount was determined to be \$923.0 million, which would require us to grow our QSBL by \$92.3 million to have the dividend rate paid to the U.S. Treasury reduced to 1.00%. Any reduction in the dividend rate paid to the U.S. Treasury does not begin until QSBL has grown by more than 2.5% over the baseline. Through December 31, 2011, Heartland's QSBL had grown by \$17.3 million, approximately \$5.8 million short of the growth necessary to begin receiving any dividend rate reductions.

Residential mortgage loans experienced an increase of \$30.7 million or 19% during 2011, primarily during the last quarter of year as we ramped up this line of business. In 2010, residential mortgage loans decreased \$11.3 million or 6%. Management anticipates that growth in our residential mortgage loan portfolio will be slower in low interest rate environments when consumers are more apt to choose 15- and 30-year fixed-rate mortgage loans which are usually sold into the secondary market. Servicing is retained on a portion of these loans so that the Bank Subsidiaries have an opportunity to continue providing their customers the excellent service they expect.

Agricultural and agricultural real estate loans outstanding increased \$12.0 million or 5% during 2011, compared to a decrease of \$5.8 million or 2% during 2010. Of the \$263.0 million in agricultural loans at year-end 2011, 75% were originated by our banks in the Midwest. Of the \$250.9 million in agricultural loans at year-end 2010, 70% were originated at our Midwestern banks. The agricultural loan portfolio is well diversified between grains, dairy, hogs and cattle, with approximately 32% being in grain production.

Consumer loans increased \$5.6 million or 3% during 2011 compared to a decrease of \$17.2 million or 7% during 2010. Consumer loans at Citizens Finance Co. comprised 27% of our total consumer loan portfolio at December 31, 2011, 24% at December 31, 2010, and 21% at December 31, 2009. Expansion of Citizens Finance Co. was put on hold until December of 2010, when its ninth office was opened in Aurora, Illinois. A tenth office was opened in Peoria, Illinois in September 2011.

Although the risk of nonpayment for any reason exists with respect to all loans, specific risks are associated with each type of loan. The primary risks associated with commercial and agricultural loans are the quality of the borrower's management and the impact of national and regional economic factors. Additionally, risks associated with commercial and agricultural real estate loans include fluctuating property values and concentrations of loans in a specific type of real estate. Repayment on loans to individuals, including those on residential real estate, are dependent on the borrower's continuing financial stability as well as the value of the collateral underlying these credits, and thus are more likely to be affected by adverse personal circumstances and deteriorating economic conditions. These risks are described in more detail in Item 1A. "Risk Factors" of this Form 10-K. We monitor loan concentrations and do not believe we have excessive concentrations in any specific industry.

Our strategy with respect to the management of these types of risks, whether loan demand is weak or strong, is to encourage the Bank Subsidiaries to follow tested and prudent loan policies and underwriting practices which include: (i) granting loans on a sound and collectible basis; (ii) ensuring that primary and secondary sources of repayment are adequate in relation to the amount of the loan; (iii) administering loan policies through a board of directors; (iv) developing and maintaining adequate diversification of the loan portfolio as a whole and of the loans within each loan category; and (v) ensuring that each loan is properly documented and, if appropriate, guaranteed by government agencies and that insurance coverage is adequate.

Loans and leases secured by real estate, either fully or partially, totaled \$1.7 billion or 70% of total loans and leases at December 31, 2011, and \$1.7 billion or 71% of total loans and leases at December 31, 2010. Approximately 60% of the non-farm, nonresidential loans are owner occupied. The largest categories within our real estate secured loans are listed below:

#### **LOANS SECURED BY REAL ESTATE**

(Dollars in thousands)

|   | <b>As of December 31,</b> |                     |
|---|---------------------------|---------------------|
|   | <b>2011</b>               | <b>2010</b>         |
| Residential real estate, excluding residential construction and residential lot loans | \$ 426,736                | \$ 389,790          |
| Industrial, manufacturing, business and commercial                                    | 199,487                   | 186,558             |
| Agriculture   | 200,204                   | 201,750             |
| Land development and lots   | 129,783                   | 152,658             |
| Retail  | 161,795                   | 168,916             |
| Office  | 136,826                   | 124,041             |
| Hotel, resort and hospitality   | 111,550                   | 97,442              |
| Warehousing   | 62,973                    | 65,196              |
| Food and beverage   | 73,196                    | 68,550              |
| Multi-family  | 66,063                    | 62,886              |
| Residential construction  | 37,685                    | 42,564              |
| All other   | 135,802                   | 137,216             |
| <b>Total loans secured by real estate</b>   | <b>\$ 1,742,100</b>       | <b>\$ 1,697,567</b> |

The table below sets forth the amounts of nonperforming loans and leases and other nonperforming assets on the dates indicated:

## NONPERFORMING ASSETS

(Dollars in thousands)

|   | As of December 31, |            |            |           |           |
|---|--------------------|------------|------------|-----------|-----------|
|   | 2011               | 2010       | 2009       | 2008      | 2007      |
| <b>Not covered under loss share agreements:</b>   |                    |            |            |           |           |
| Nonaccrual loans and leases   | \$ 57,435          | \$ 90,512  | \$ 78,118  | \$ 76,953 | \$ 30,694 |
| Loans and leases contractually past due 90 days or more   | —                  | 85         | 17         | 1,005     | 1,134     |
| Total nonperforming loans and leases  | 57,435             | 90,597     | 78,135     | 77,958    | 31,828    |
| Other real estate   | 43,506             | 31,731     | 30,205     | 11,750    | 2,195     |
| Other repossessed assets  | 648                | 302        | 501        | 1,484     | 438       |
| Total nonperforming assets not covered under loss share agreements  | \$ 101,589         | \$ 122,630 | \$ 108,841 | \$ 91,192 | \$ 34,461 |
| <b>Covered under loss share agreements:</b>   |                    |            |            |           |           |
| Nonaccrual loans and leases   | \$ 3,345           | \$ 4,901   | \$ 4,170   | \$ —      | \$ —      |
| Loans and leases contractually past due 90 days or more   | —                  | —          | —          | —         | —         |
| Total nonperforming loans and leases  | 3,345              | 4,901      | 4,170      | —         | —         |
| Other real estate   | 881                | 271        | 363        | —         | —         |
| Other repossessed assets  | —                  | —          | —          | —         | —         |
| Total nonperforming assets covered under loss share agreements  | \$ 4,226           | \$ 5,172   | \$ 4,533   | \$ —      | \$ —      |
| Restructured loans <sup>(1)</sup>   | \$ 25,704          | \$ 23,719  | \$ 46,656  | \$ —      | \$ —      |
| Nonperforming loans and leases not covered under loss share agreements to total loans and leases receivable                 | 2.31%              | 3.87%      | 3.35%      | 3.24%     | 1.40%     |
| Nonperforming assets not covered under loss share agreements to total loans and leases receivable plus repossessed property | 4.02%              | 5.16%      | 4.61%      | 3.77%     | 1.51%     |
| Nonperforming assets not covered under loss share agreements to total assets  | 2.39%              | 3.07%      | 2.71%      | 2.51%     | 1.06%     |

(1) Represents accruing restructured loans performing according to their restructured terms.

The schedules below summarize the changes in Heartland's nonperforming assets, including those covered by loss share agreements, during 2011:

| (Dollars in thousands)                          | Nonperforming<br>Loans | Other Real<br>Estate<br>Owned | Other<br>Repossessed<br>Assets | Total<br>Nonperforming<br>Assets |
|---|------------------------|-------------------------------|--------------------------------|----------------------------------|
| December 31, 2010                               | \$ 95,498              | \$ 32,002                     | \$ 302                         | \$ 127,802                       |
| Loan foreclosures                               | (41,933)               | 41,272                        | 661                            | —                                |
| Net loan charge offs                            | (35,250)               | —                             | —                              | (35,250)                         |
| New nonperforming loans                         | 75,676                 | —                             | —                              | 75,676                           |
| Reduction of nonperforming loans <sup>(1)</sup> | (33,211)               | —                             | —                              | (33,211)                         |
| OREO/Repossessed sales proceeds                 | —                      | (21,635)                      | (234)                          | (21,869)                         |
| OREO/Repossessed assets writedowns, net         | —                      | (7,252)                       | (52)                           | (7,304)                          |
| Net activity at Citizens Finance Co.            | —                      | —                             | (29)                           | (29)                             |
| December 31, 2011                               | \$ 60,780              | \$ 44,387                     | \$ 648                         | \$ 105,815                       |

(1) Includes principal reductions and transfers to performing status.



We regularly monitor and continue to develop systems to oversee the quality of our loan portfolio. Under our internal loan review program, loan review officers are responsible for reviewing existing loans and leases, testing loan ratings assigned by loan officers, identifying potential problem loans and leases and monitoring the adequacy of the allowance for loan and lease losses at the Bank Subsidiaries. An integral part of our loan review program is a loan rating system, under which a rating is assigned to each loan and lease within the portfolio based on the borrower's financial position, repayment ability, collateral position and repayment history.

Nonperforming loans and leases, exclusive of those covered under the loss sharing agreements, were \$57.4 million or 2.31% of total loans and leases receivable at December 31, 2011, compared to \$90.6 million or 3.87% of total loans and leases receivable at December 31, 2010, and \$78.1 million or 3.35% of total loans and leases receivable at December 31, 2009. Approximately 57%, or \$32.7 million, of our nonperforming loans have individual loan balances exceeding \$1.0 million. These nonperforming loans, to an aggregate 15 borrowers, are primarily concentrated in our banks serving the Western states, with \$8.8 million originated by Arizona Bank & Trust, \$8.2 million originated by New Mexico Bank & Trust, \$4.5 million originated by Wisconsin Community Bank, \$4.5 million originated by Rocky Mountain Bank, \$3.9 million originated by Riverside Community Bank and \$2.8 million originated by Galena State Bank & Trust Co. At December 31, 2010, approximately 62%, or \$56.0 million, had individual loan balances exceeding \$1.0 million. These nonperforming loans were to 25 borrowers, with \$17.9 million originated by Rocky Mountain Bank, \$11.8 million originated by Summit Bank & Trust, \$8.9 million originated by Wisconsin Community Bank, \$8.8 million originated by New Mexico Bank & Trust, \$5.2 million originated by Arizona Bank & Trust, \$1.8 million originated by Galena State Bank & Trust Co. and \$1.6 million originated by Riverside Community Bank. The portion of our nonperforming loans covered by government guarantees was \$2.7 million at December 31, 2011, \$3.7 million at December 31, 2010, and \$3.3 million at December 31, 2009.

The industry breakdown for nonperforming loans with individual balances exceeding \$1.0 million at December 31, 2011, as identified using the North American Industry Classification System (NAICS), was \$14.4 million for lot and land development and \$6.7 million for construction and development. The remaining \$11.6 million was distributed among seven other industries. At December 31, 2010, the industry breakdown for nonperforming loans with individual balances exceeding \$1.0 million was \$13.1 million to lessors of real estate, \$11.6 million for lot and land development, \$6.6 million for other activities related to real estate and \$3.8 million for construction and development. The remaining \$20.9 million was distributed among 9 other industries.

Delinquencies in each of the loan portfolios continues to be well managed and no significant adverse trends have been identified. Loans delinquent between 30 and 89 days as a percentage of total loans were 0.23% at December 31, 2011, compared to 0.54% at September 30, 2011, 0.60% at June 30, 2011, 0.61% at March 31, 2011, and 0.67% at December 31, 2010.

Other real estate owned, exclusive of assets covered under loss sharing agreements, was \$44.4 million at December 31, 2011, compared to \$32.0 million at December 31, 2010. Liquidation strategies have been identified for all the assets held in other real estate owned. Management continues with its plans to market these properties through an orderly liquidation process instead of under a quick liquidation process that would likely result in discounts greater than the projected carrying costs. During 2011, \$21.8 million of other real estate owned was sold, \$5.4 million during the fourth quarter, \$6.2 million during the third quarter, \$4.9 million during the second quarter and \$5.3 million during the first quarter.

In certain circumstances, we may modify the terms of a loan to maximize the collection of amounts due. In most cases, the modification is either a reduction in interest rate, conversion to interest only payments, extension of the maturity date or a reduction in the principal balance. Generally, the borrower is experiencing financial difficulties or is expected to experience difficulties in the near-term, so concessionary modification is granted to the borrower that would otherwise not be considered. Restructured loans accrue interest as long as the borrower complies with the revised terms and conditions and has demonstrated repayment performance at a level commensurate with the modified terms over several payment cycles. Although many of our loan restructurings occur on a case-by-case basis in connection with ongoing loan collection processes, we have also participated in certain restructuring programs for residential real estate borrowers. In general, certain residential real estate borrowers facing an interest rate reset that are current in their repayment status, are allowed to retain the lower of their existing interest rate or the market interest rate as of their interest reset date. In addition, during 2009, our Bank Subsidiaries began participating in the U.S. Department of the Treasury Home Affordable Modification Program ("HAMP") for loans in its servicing portfolio. HAMP gives qualifying homeowners an opportunity to refinance into more affordable monthly payments, with the U.S. Department of the Treasury compensating us for a portion of the reduction in monthly amounts due from borrowers participating in this program. We also utilize a similar mortgage loan restructuring program for certain borrowers within our portfolio loans.

We had an aggregate balance of \$34.6 million in restructured loans at December 31, 2011, of which \$8.9 million was classified as nonaccrual and \$25.7 million was accruing interest according to the restructured terms. At December 31, 2010, we had an aggregate balance of \$36.4 million in restructured loans, of which \$12.7 million was classified as nonaccrual and \$23.7 million was accruing interest according to the restructured terms.

At December 31, 2011, \$90.6 million or 56% of the consumer loans originated by the Bank Subsidiaries were in home equity lines of credit ("HELOC's") compared to \$94.9 million or 58% at December 31, 2010, and \$104.4 million or 56% at December 31, 2009. Under our policy guidelines for the underwriting of these lines of credit, the customer may receive advances of up to 90% of the value of the property securing the line, provided the customer qualifies for Tier I classification, our internal ranking for customers considered to possess a high credit quality profile. Additionally, to qualify for advances up to 90% of the value of the property securing the line, the first mortgage must be held by Heartland and the customer must escrow for both taxes and insurance. Otherwise, HELOC's are established at an 80% loan to value.

The Bank Subsidiaries have not been active in the origination of subprime loans. Consistent with our community banking model, which includes meeting the legitimate credit needs within the communities served, the Bank Subsidiaries may make loans to borrowers possessing subprime characteristics if there are mitigating factors present that reduce the potential default risk of the loan.

### **Allowance For Loan And Lease Losses**

The process we use to determine the adequacy of the allowance for loan and lease losses is considered a critical accounting practice for Heartland. The allowance for loan and lease losses represents management's estimate of identified and unidentified probable losses in the existing loan portfolio. For additional details on the specific factors considered, refer to the critical accounting policies section of this report.

The allowance for loan and lease losses at December 31, 2011, was 1.48% of loans and leases and 64.09% of nonperforming loans compared to 1.82% of loans and leases and 47.12% of nonperforming loans at December 31, 2010, and 1.80% of loans and leases and 53.56% of nonperforming loans at December 31, 2009. The allowance for loan and lease losses as a percentage of loans and leases declined by year-end 2011 as several credit relationships considered impaired, for which specific reserves had been provided, were charged-off or transitioned to other real estate owned. The provision for loan losses was \$29.4 million in 2011 compared to \$32.5 million in 2010 and \$39.4 million in 2009. Although the aggregate annual provision for loan losses has moderated, additions to the allowance for loan and lease losses continued during 2011 as the lack of significant economic recovery and the long-term affect of adverse economic conditions impacted individual credits and continued to impact the value of collateral when appraisals were obtained. The allowance for loan and lease losses related to total impaired loans was \$5.5 million at December 31, 2011, \$12.2 million at December 31, 2010, and \$13.0 million at December 31, 2009.

The amount of net charge-offs not covered by loss share agreements recorded by us was \$36.3 million during 2011 compared to \$30.9 million during 2010. As a percentage of average loans and leases, net charge-offs were 1.46% during 2011 and 1.31% during 2010. A large portion of the net charge-offs during both years was related to nonfarm nonresidential real estate and construction, land development and other land loans, including residential lot loans. We recognize charge-offs on certain collateral dependent loans by writing down the loan balance to an estimated net realizable value based on the anticipated disposition value. Citizens Finance Co., our consumer finance subsidiary, experienced net charge-offs of \$1.6 million during both 2011 and 2010. Net losses as a percentage of average loans, net of unearned, at Citizens were 2.99% for 2011 compared to 3.35% for 2010 and 4.27% for 2009. Loans with payments past due for more than thirty days at Citizens were 3.79% of gross loans at year-end 2011 compared to 4.39% at year-end 2010 and 5.41% at year-end 2009. Although we may periodically experience a charge-off of more significance on an individual credit, we feel our credit culture remains solid.

The first table below summarizes activity in the allowance for loan and lease losses for the years indicated, including amounts of loans and leases charged off, amounts of recoveries, additions to the allowance charged to income, additions related to acquisitions and the ratio of net charge-offs to average loans and leases outstanding. The second table below shows our allocation of the allowance for loan and lease losses by types of loans and leases and the amount of unallocated reserves.

## ANALYSIS OF ALLOWANCE FOR LOAN AND LEASE LOSSES

(Dollars in thousands)

|  | As of December 31, |           |           |           |           |
|--|--------------------|-----------|-----------|-----------|-----------|
|  | 2011               | 2010      | 2009      | 2008      | 2007      |
| Allowance at beginning of year               | \$ 42,693          | \$ 41,848 | \$ 35,651 | \$ 32,993 | \$ 29,981 |
| Charge-offs:                                 |                    |           |           |           |           |
| Commercial and commercial real estate        | 32,474             | 27,191    | 26,883    | 22,487    | 5,226     |
| Residential real estate                      | 1,878              | 1,641     | 1,869     | 1,010     | 237       |
| Agricultural and agricultural real estate    | 167                | 301       | 496       | 33        | —         |
| Consumer                                     | 5,461              | 4,917     | 4,712     | 4,217     | 3,101     |
| Lease financing                              | —                  | —         | 1,005     | —         | —         |
| Total charge-offs                            | 39,980             | 34,050    | 34,965    | 27,747    | 8,564     |
| Recoveries:                                  |                    |           |           |           |           |
| Commercial and commercial real estate        | 3,919              | 1,585     | 1,073     | 226       | 983       |
| Residential real estate                      | 46                 | 19        | 79        | 18        | 4         |
| Agricultural and agricultural real estate    | 33                 | 152       | 32        | 177       | —         |
| Consumer                                     | 732                | 631       | 601       | 665       | 654       |
| Lease financing                              | —                  | —         | —         | —         | —         |
| Total recoveries                             | 4,730              | 2,387     | 1,785     | 1,086     | 1,641     |
| Net charge-offs <sup>(1)(2)</sup>            | 35,250             | 31,663    | 33,180    | 26,661    | 6,923     |
| Provision for loan and lease losses          | 29,365             | 32,508    | 39,377    | 29,319    | 10,073    |
| Reduction related to discontinued operations | —                  | —         | —         | —         | (138)     |
| Allowance at end of year                     | \$ 36,808          | \$ 42,693 | \$ 41,848 | \$ 35,651 | \$ 32,993 |
| Net charge-offs to average loans and leases  | 1.46%              | 1.31%     | 1.38%     | 1.15%     | 0.30%     |

(1) Includes net charge-offs at Citizens Finance Co. of \$1,608 for 2011, \$1,605 for 2010, \$1,942 for 2009, \$2,012 for 2008 and \$1,646 for 2007.

(2) Includes net charge-offs on loans covered under loss share agreements of (\$1,065) for 2011, \$798 for 2010 and \$1,344 for 2009.

## ALLOCATION OF ALLOWANCE FOR LOAN AND LEASE LOSSES

(Dollars in thousands)

|  | As of December 31, |  |           |  |           |  |           |  |           |  |
|--|--------------------|--|-----------|--|-----------|--|-----------|--|-----------|--|
|  | 2011               |  | 2010      |  | 2009      |  | 2008      |  | 2007      |  |
|  | Amount             | Loan Category to Gross Loans & Leases Receivable | Amount    | Loan Category to Gross Loans & Leases Receivable | Amount    | Loan Category to Gross Loans & Leases Receivable | Amount    | Loan Category to Gross Loans & Leases Receivable | Amount    | Loan Category to Gross Loans & Leases Receivable |
| Commercial and commercial real estate <sup>(1)</sup> | \$ 25,168          | 72.74%   | \$ 30,841 | 73.18%   | \$ 33,585 | 71.50%   | \$ 23,133 | 71.30%   | \$ 22,564 | 71.48%   |
| Residential real estate                              | 3,001              | 7.82   | 2,381     | 6.97   | 1,691     | 7.49   | 2,007     | 8.46   | 2,345     | 9.50   |
| Agricultural and agricultural real estate            | 1,763              | 10.57  | 2,147     | 10.68  | 2,852     | 10.99  | 2,013     | 10.28  | 1,868     | 9.88   |
| Consumer   | 6,874              | 8.85   | 6,315     | 9.13   | 3,566     | 9.92   | 3,322     | 9.72   | 2,954     | 8.74   |
| Lease financing                                      | 2                  | 0.02   | 9         | 0.04   | 17        | 0.10   | 97        | 0.24   | 128       | 0.40   |
| Unallocated  | —                  |  | 1,000     |  | 137       |  | 5,079     |  | 3,134     |  |
| Total allowance for loan and lease losses            | \$ 36,808          |  | \$ 42,693 |  | \$ 41,848 |  | \$ 35,651 |  | \$ 32,993 |  |

(1) For 2011, the amount allocated to commercial was \$10,547 and the amount allocated to commercial real estate was \$14,621. For 2010, the amount allocated to commercial was \$10,525 and the amount allocated to commercial real estate was \$20,316.

## Securities

The composition of our securities portfolio is managed to maximize the total return on the portfolio while considering the impact it has on our asset/liability position and liquidity needs. Securities represented 31% of total assets at December 31, 2011, and 32% of total assets at December 31, 2010. Total available for sale securities as of December 31, 2011, were \$1.27 billion, an increase of \$63.3 million or 5% from year-end 2010. Total available for sale securities as of December 31, 2010, were \$1.20 billion, an increase of \$69.2 million or 6% from year-end 2009. Additional securities were purchased during both years as loan growth slowed.

The composition of the securities portfolio shifted from an emphasis in U.S. government corporations and agencies to mortgage-backed securities as the spread on mortgage-backed securities widened in comparison to government agency securities. The percentage of mortgage-backed securities was 63% at December 31, 2011, compared to 48% at year-end 2010. A portion of the new mortgage-backed securities was in reverse mortgage products. Nearly 80% of Heartland's mortgage-backed securities are issuances of government-sponsored enterprises as of December 31, 2011.

During 2010, the composition of the securities portfolio shifted from an emphasis in mortgage-backed securities to U.S. government corporations and agencies as the spread on mortgage-backed securities narrowed in comparison to government agency securities. The percentage of mortgage-backed securities was 48% at year-end 2010 compared to 53% at year-end 2009.

The table below presents the composition of the securities portfolio including trading, available for sale and held to maturity, by major category:

### SECURITIES PORTFOLIO COMPOSITION

(Dollars in thousands)

|  | As of December 31, |                |                    |                |                    |                |
|--|--------------------|----------------|--------------------|----------------|--------------------|----------------|
|  | 2011               |                | 2010               |                | 2009               |                |
|  | Amount             | % of Portfolio | Amount             | % of Portfolio | Amount             | % of Portfolio |
| U.S. government corporations and agencies        | \$ 107,147         | 8.08%          | \$ 320,007         | 25.30%         | \$ 279,441         | 23.78%         |
| Mortgage-backed securities                       | 834,185            | 62.88          | 609,865            | 48.23          | 623,949            | 53.09          |
| Obligations of states and political subdivisions | 335,799            | 25.31          | 294,259            | 23.27          | 238,893            | 20.33          |
| Other securities                                 | 49,461             | 3.73           | 40,433             | 3.20           | 32,934             | 2.80           |
| Total  | <u>\$1,326,592</u> | <u>100.00%</u> | <u>\$1,264,564</u> | <u>100.00%</u> | <u>\$1,175,217</u> | <u>100.00%</u> |

At December 31, 2011, we had \$23.9 million of equity securities, including capital stock in the various Federal Home Loan Banks of which the Bank Subsidiaries are members and all of which were classified as available for sale. The tables below present the contractual maturities for the debt securities in the securities portfolio at December 31, 2011, by major category and classification as available for sale or held to maturity, using estimated prepayment speeds for mortgage-backed securities:

### SECURITIES AVAILABLE FOR SALE PORTFOLIO MATURITIES

(Dollars in thousands)

|   | Within One Year   |              | After One But Within Five Years |              | After Five But Within Ten Years |              | After Ten Years   |              | Total              |              |
|---|-------------------|--------------|---------------------------------|--------------|---------------------------------|--------------|-------------------|--------------|--------------------|--------------|
|   | Amount            | Yield        | Amount                          | Yield        | Amount                          | Yield        | Amount            | Yield        | Amount             | Yield        |
| U.S. government corporations and agencies                       | \$ 1,002          | 0.92%        | \$ 86,992                       | 1.35%        | \$ 16,125                       | 2.71%        | \$ 3,028          | 0.87%        | \$ 107,147         | 1.54%        |
| Mortgage-backed securities                                      | 171,438           | 3.30         | 417,566                         | 3.31         | 38,548                          | 4.22         | 197,502           | 4.22         | 825,054            | 3.77         |
| Obligations of states and political subdivisions <sup>(1)</sup> | 2,805             | 6.50         | 32,776                          | 5.46         | 61,544                          | 5.07         | 189,545           | 5.47         | 286,670            | 5.39         |
| Corporate debt securities                                       | —                 | —            | 5,123                           | 2.12         | 4,784                           | 4.00         | 15,346            | 9.75         | 25,253             | 7.11         |
| Total   | <u>\$ 175,245</u> | <u>3.34%</u> | <u>\$ 542,457</u>               | <u>3.11%</u> | <u>\$ 121,001</u>               | <u>4.45%</u> | <u>\$ 405,421</u> | <u>4.99%</u> | <u>\$1,244,124</u> | <u>4.03%</u> |

(1) Rates on obligations of states and political subdivisions have been adjusted to tax equivalent yields using a 34% tax rate.

## SECURITIES HELD TO MATURITY PORTFOLIO MATURITIES

(Dollars in thousands)

|   | Within One Year |       | After One But Within Five Years |       | After Five But Within Ten Years |       | After Ten Years |       | Total     |       |
|---|-----------------|-------|---------------------------------|-------|---------------------------------|-------|-----------------|-------|-----------|-------|
|   | Amount          | Yield | Amount                          | Yield | Amount                          | Yield | Amount          | Yield | Amount    | Yield |
| Mortgage-backed securities                                      | \$ 1,259        | 6.30% | \$ 6,952                        | 8.31% | \$ 920                          | 5.75% | \$ —            | —%    | \$ 9,131  | 7.75% |
| Obligations of states and political subdivisions <sup>(1)</sup> | —               | —     | 512                             | 6.15  | 773                             | 9.70  | 47,844          | 7.37  | 49,129    | 7.39  |
| Total   | \$ 1,259        | 6.30% | \$ 7,464                        | 8.16% | \$ 1,693                        | 7.55% | \$ 47,844       | 7.37% | \$ 58,260 | 7.45% |

(1) Rates on obligations of states and political subdivisions have been adjusted to tax equivalent yields using a 34% tax rate.

Although there remains a net unrealized aggregate gain on the debt securities held in our available for sale portfolio, some of those securities had market values below their amortized cost basis at December 31, 2011. Because the majority of the decline in market value is attributable to changes in interest rates and not credit quality, and because we have the ability and intent to hold those investments until a recovery of fair value, which may be maturity, we did not consider those investments to be other-than-temporarily impaired at December 31, 2011. See Note 3 to our consolidated financial statements for further discussion regarding unrealized losses on our securities portfolio.

## Deposits

The table below sets forth the distribution of our average deposit account balances and the average interest rates paid on each category of deposits for the years indicated:

### AVERAGE DEPOSITS

(Dollars in thousands)

|                                    | For the years ended December 31, |                     |                       |                  |                     |                       |                  |                     |                       |
|------------------------------------|----------------------------------|---------------------|-----------------------|------------------|---------------------|-----------------------|------------------|---------------------|-----------------------|
|                                    | 2011                             |                     |                       | 2010             |                     |                       | 2009             |                     |                       |
|                                    | Average Deposits                 | Percent of Deposits | Average Interest Rate | Average Deposits | Percent of Deposits | Average Interest Rate | Average Deposits | Percent of Deposits | Average Interest Rate |
| Demand deposits                    | \$ 667,952                       | 21.45%              | —%                    | \$ 536,053       | 17.63%              | —%                    | \$ 437,468       | 15.36%              | —%                    |
| Savings                            | 1,589,697                        | 51.05               | 0.57                  | 1,557,658        | 51.24               | 0.88                  | 1,282,212        | 45.03               | 1.44                  |
| Time deposits less than \$100,000  | 590,767                          | 18.97               | 2.40                  | 649,892          | 21.38               | 2.63                  | 754,814          | 26.51               | 3.06                  |
| Time deposits of \$100,000 or more | 265,664                          | 8.53                | 2.23                  | 296,325          | 9.75                | 2.54                  | 373,159          | 13.10               | 3.00                  |
| Total deposits                     | \$3,114,080                      | 100.00%             |                       | \$3,039,928      | 100.00%             |                       | \$2,847,653      | 100.00%             |                       |

Total average deposits experienced an increase of \$74.2 million or 2% during 2011 and \$192.3 million or 7% during 2010. Exclusive of brokered deposits, total average deposits increased \$71.0 million or 2% during 2011 and \$199.7 million or 7% during 2010. For 2011, the Bank Subsidiaries experiencing growth were Dubuque Bank and Trust Company, Riverside Community Bank, Wisconsin Community Bank, New Mexico Bank & Trust and Minnesota Bank & Trust. For 2010, all of the Bank Subsidiaries except for Rocky Mountain Bank and First Community Bank experienced growth in nonbrokered deposits. During both years, this growth was weighted more heavily in our Midwestern markets, which were responsible for 86% of the growth during 2011 and 53% of the growth during 2010. The percentage of our total average deposit balances attributable to branch banking offices in our Western markets was 41% during 2011, 42% during 2010 and 41% during 2009.

The composition of Heartland's deposits continued to shift from higher cost certificates of deposit to no cost demand deposits during both years, as average demand deposits increased \$131.9 million or 25% during 2011 and \$98.6 million or 23% during 2010. The result is an improving mix of total deposits, with demand deposits representing 22%, savings representing 52% and time deposits representing 26%. At year-end 2010, demand deposits represented 19% of total deposits, savings represented 51% and time deposits represented 30%. Additionally, commercial and retail customers have continued to build cash reserves. The percentage of our total average demand deposit balances attributable to branch banking offices in our Western markets was 47% during 2011 and 53% during both 2010 and 2009.

Average savings deposit balances increased by \$32.0 million or 2% during 2011 and \$275.4 million or 21% during 2010. The percentage of our total average savings deposit balances attributable to branch banking offices in our Western markets was 38% in 2011 and 39% in both 2010 and 2009.

Average time deposits, excluding brokered time deposits, decreased \$92.9 million or 10% during 2011 and \$174.4 million or 16% during 2010. The decrease in time deposits during both years was attributable to an increased emphasis on growing our customer base in non-maturity deposit products instead of higher-cost certificates of deposit. The Bank Subsidiaries priced time deposit products competitively to retain existing relationship-based deposit customers, but not to retain certificate of deposit only customers or to attract new customers. Additionally, due to the low interest rates, many certificate of deposit customers elected to place their maturing balances in checking or savings accounts while waiting for interest rates to improve. The percentage of our total average time deposit balances attributable to branch banking offices in our Western markets was 41% during 2011, 35% during 2010 and 38% during 2009.

Average brokered time deposits as a percentage of total average deposits were 1% during both 2011 and 2010 compared to 2% during 2009. The reliance on brokered time deposits has decreased during more recent years as the Bank Subsidiaries were able to grow deposits in their own markets at comparable or lower interest rates.

The following table sets forth the amount and maturities of time deposits of \$100,000 or more at December 31, 2011:

#### **TIME DEPOSITS \$100,000 AND OVER**

(Dollars in thousands)

|                                 | <b>December 31, 2011</b> |
|---------------------------------|--------------------------|
| 3 months or less                | \$ 40,842                |
| Over 3 months through 6 months  | 24,945                   |
| Over 6 months through 12 months | 47,731                   |
| Over 12 months                  | 133,973                  |
|                                 | <u>\$ 247,491</u>        |

#### **Borrowed Funds**

Short-term borrowings generally include federal funds purchased, treasury tax and loan note options, securities sold under agreement to repurchase, short-term Federal Home Loan Bank ("FHLB") advances and discount window borrowings from the Federal Reserve Bank. These funding alternatives are utilized in varying degrees depending on their pricing and availability. The amount of short-term borrowings was \$270.1 million at year-end 2011, an increase of 14% from \$235.9 million at year-end 2010, which in turn represented a 45% increase from \$162.4 million at year-end 2009. The increases in both years were primarily due to activity in retail repurchase agreements which totaled \$253.5 million at December 31, 2011, \$212.7 million at December 31, 2010, and \$145.6 million at December 31, 2009. All of the Bank Subsidiaries provide retail repurchase agreements to their customers as a cash management tool, sweeping excess funds from demand deposit accounts into these agreements. This source of funding does not increase the reserve requirements of the Bank Subsidiaries. Although the aggregate balance of these retail repurchase agreements is subject to variation, the account relationships represented by these balances are principally local.

Also included in short-term borrowings are the revolving credit lines Heartland has with two unaffiliated banks, primarily to provide working capital to Heartland. These credit lines may also be used to fund the operations of Heartland Community Development Inc., a wholly-owned subsidiary of Heartland formed to hold and manage certain nonperforming loans and assets and to allow the liquidation of those assets at a time that is more economically advantageous. Under these unsecured revolving credit lines, Heartland may borrow up to \$10.0 million at any one time. There was no balance outstanding on these revolving credit lines at December 31, 2011, compared to a balance of \$5.0 million outstanding at December 31, 2010.

The following table reflects information regarding our short-term borrowings as of December 31, 2011, 2010 and 2009:

### SHORT-TERM BORROWINGS

(Dollars in thousands)

|   | As of or for the years ended<br>December 31, |            |            |
|---|--|------------|------------|
|   | 2011   | 2010       | 2009       |
| Balance at end of period                    | \$ 270,081                                   | \$ 235,864 | \$ 162,349 |
| Maximum month-end amount outstanding        | 270,081                                      | 235,864    | 205,747    |
| Average month-end amount outstanding        | 197,527                                      | 198,382    | 140,289    |
| Weighted average interest rate at year-end  | 0.35%  | 0.48%      | 0.58%      |
| Weighted average interest rate for the year | 0.44%  | 0.58%      | 0.51%      |

Other borrowings include all debt arrangements Heartland and its subsidiaries have entered into with original maturities that extend beyond one year. As of December 31, 2011, the amount of other borrowings was \$372.8 million, an increase of \$10.3 million or 3% since year-end 2010. On December 3, 2010, we completed a private debt offering of our senior notes. The notes were sold in a private placement to various accredited investors. A total of \$24.5 million was issued in five private transactions beginning on October 25, 2010, and ending on December 3, 2010. The senior notes are unsecured, bear interest at 5% per annum payable quarterly and mature on December 1, 2015. An additional \$3.0 million of our senior notes was issued to one additional accredited investor on March 11, 2011, increasing the total amount of senior notes outstanding to \$27.5 million, all of which was outstanding at December 31, 2011. Prior to April 2011, Heartland maintained credit lines with two unaffiliated banks, one of which provided borrowing authority for \$15.0 million and one of which provided borrowing authority for \$5.0 million. On April 20, 2011, Heartland entered into a debt arrangement with one of these banks to convert the \$15.0 million revolving line of credit into a \$15.0 million amortizing term loan with a maturity date of April 20, 2016, and to add \$5.0 million in borrowing capacity in the form of a revolving line of credit with a maturity date of April 20, 2013. At the same time, Heartland entered into an interest rate swap transaction, designated as a cash flow hedge, with the unaffiliated bank to fix the rate on the term loan at 5.14% for the full 5-year term. Accordingly, after this debt arrangement, Heartland continues to have credit lines with two unaffiliated banks, both with a revolving borrowing capacity of \$5.0 million, and a \$15.0 million amortizing term loan with one of these banks. At December 31, 2011, Heartland had no outstanding balance on either credit line.

Other borrowings include wholesale repurchase agreements which totaled \$85.0 million at both December 31, 2011, and December 31, 2010. The balances outstanding on trust preferred capital securities issued by Heartland are also included in other borrowings. A schedule of our trust preferred offerings outstanding as of December 31, 2011, is as follows:

### TRUST PREFERRED OFFERINGS

(Dollars in thousands)

| Amount Issued     | Issuance Date | Interest Rate    | Interest Rate as of 12/31/11 <sup>(1)</sup> | Maturity Date | Callable Date |
|-------------------|---------------|------------------|---|---------------|---------------|
| \$ 5,000          | 08/07/2000    | 10.60%           | 10.60%                                      | 09/07/2030    | 03/07/2012    |
| 20,000            | 10/10/2003    | 8.25%            | 8.25%                                       | 10/10/2033    | 03/31/2012    |
| 25,000            | 03/17/2004    | 2.75% over Libor | 3.30% <sup>(2)</sup>                        | 03/17/2034    | 03/17/2012    |
| 20,000            | 01/31/2006    | 1.33% over Libor | 1.73% <sup>(3)</sup>                        | 04/07/2036    | 04/07/2012    |
| 20,000            | 06/21/2007    | 6.75%            | 6.75%                                       | 09/15/2037    | 06/15/2012    |
| 20,000            | 06/26/2007    | 1.48% over Libor | 2.01% <sup>(4)</sup>                        | 09/01/2037    | 09/01/2012    |
| <u>\$ 110,000</u> |               |                  |   |               |               |

(1) Effective weighted average interest rate as of December 31, 2011, was 6.13% due to interest rate swap transactions on the variable rate securities as discussed in Note 11 to Heartland's consolidated financial statements.

(2) Effective interest rate as of December 31, 2011, was 5.33% due to an interest rate swap transaction as discussed in Note 11 to Heartland's consolidated financial statements.

(3) Effective interest rate as of December 31, 2011, was 4.69% due to an interest rate swap transaction as discussed in Note 11 to Heartland's consolidated financial statements.

(4) Effective interest rate as of December 31, 2011, was 4.70% due to an interest rate swap transaction as discussed in Note 11 to Heartland's consolidated financial statements.



Also in other borrowings are the bank subsidiaries' borrowings from the FHLB. All of the bank subsidiaries own FHLB stock in either Chicago, Dallas, Des Moines, Seattle, San Francisco or Topeka, enabling them to borrow funds from their respective FHLB for short- or long-term purposes under a variety of programs. FHLB borrowings at December 31, 2011, totaled \$132.3 million compared to \$135.7 million at December 31, 2010, and \$199.1 million at December 31, 2009. Total FHLB borrowings at December 31, 2011, had an average rate of 3.33% and an average maturity of 2.75 years when considering the earliest possible call date on these advances. For additional information regarding these borrowings see Note 10 to our consolidated financial statements.

In January 2012, we issued an additional \$10.0 million of our senior notes to two of the initial accredited investors. Additionally, we extended the maturities on a portion of the existing senior notes such that \$17.5 million remained at the original maturity date of December 1, 2015, \$7.0 million will mature on each of February 1, 2017, and February 1, 2018, and \$6.0 million will mature on February 1, 2019. The senior notes continue to be unsecured and bear interest at 5.00% per annum payable quarterly. A portion of the additional senior notes was used to redeem the \$5.0 million trust preferred capital securities callable on March 7, 2012, that were at a fixed interest rate of 10.60%. The remaining unamortized issuance costs of \$302,000 were expensed under the noninterest expense category upon redemption.

## CAPITAL RESOURCES

Heartland's risk-based capital ratios, which take into account the different credit risks among banks' assets, met all capital adequacy requirements over the past three years. Tier 1 and total risk-based capital ratios were 14.08% and 15.87%, respectively, on December 31, 2011, compared to 14.06% and 16.23%, respectively, on December 31, 2010, and 13.53% and 15.20%, respectively, on December 31, 2009. At December 31, 2011, our leverage ratio, the ratio of Tier 1 capital to total average assets, was 10.24% compared to 9.92% and 9.64% at December 31, 2010 and 2009, respectively. Heartland and our Bank Subsidiaries have been, and will continue to be, managed to meet the well-capitalized requirements under the regulatory framework for prompt corrective action. To be categorized as well capitalized under the regulatory framework, bank holding companies and banks must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios of 10%, 6% and 5%, respectively. The most recent notification from the FDIC categorized us and each of our Bank Subsidiaries as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed each institution's category.

Heartland's capital ratios are detailed in the table below:

### RISK-BASED CAPITAL RATIOS<sup>(1)</sup>

(Dollars in thousands)

|                                    | As of and for the year ended December 31, |        |              |        |              |        |
|------------------------------------|---|--------|--------------|--------|--------------|--------|
|                                    | 2011                                      |        | 2010         |        | 2009         |        |
|                                    | Amount                                    | Ratio  | Amount       | Ratio  | Amount       | Ratio  |
| Capital Ratios:                    |   |        |              |        |              |        |
| Tier 1 capital                     | \$ 427,145                                | 14.08% | \$ 403,357   | 14.06% | \$ 380,334   | 13.53% |
| Tier 1 capital minimum requirement | 121,357                                   | 4.00%  | 114,760      | 4.00%  | 112,471      | 4.00%  |
| Excess                             | \$ 305,788                                | 10.08% | \$ 288,597   | 10.06% | \$ 267,863   | 9.53%  |
| Total capital                      | \$ 481,513                                | 15.87% | \$ 465,666   | 16.23% | \$ 427,523   | 15.20% |
| Total capital minimum requirement  | 242,715                                   | 8.00%  | 229,521      | 8.00%  | 224,943      | 8.00%  |
| Excess                             | \$ 238,798                                | 7.87%  | \$ 236,145   | 8.23%  | \$ 202,580   | 7.20%  |
| Total risk-adjusted assets         | \$ 3,033,935                              |        | \$ 2,869,010 |        | \$ 2,811,782 |        |

(1) Based on the risk-based capital guidelines of the Federal Reserve, a bank holding company is required to maintain a Tier 1 capital to risk-adjusted assets ratio of 4.00% and total capital to risk-adjusted assets ratio of 8.00%.



## LEVERAGE RATIOS<sup>(1)</sup>

(Dollars in thousands)

|   | As of and for the year ended December 31, |        |              |       |              |       |
|---|---|--------|--------------|-------|--------------|-------|
|   | 2011                                      |        | 2010         |       | 2009         |       |
|   | Amount                                    | Ratio  | Amount       | Ratio | Amount       | Ratio |
| Capital Ratios:                                   |   |        |              |       |              |       |
| Tier 1 capital                                    | \$ 427,145                                | 10.24% | \$ 403,357   | 9.92% | \$ 380,334   | 9.64% |
| Tier 1 capital minimum requirement <sup>(2)</sup> | 166,865                                   | 4.00%  | 162,580      | 4.00% | 157,830      | 4.00% |
| Excess  | \$ 260,280                                | 6.24%  | \$ 240,777   | 5.92% | \$ 222,504   | 5.64% |
| Average adjusted assets                           | \$ 4,171,625                              |        | \$ 4,064,508 |       | \$ 3,945,757 |       |

(1) The leverage ratio is defined as the ratio of Tier 1 capital to average total assets.

(2) We have established a minimum target leverage ratio of 4.00%. Based on Federal Reserve guidelines, a bank holding company generally is required to maintain a leverage ratio of 3.00% plus an additional cushion of at least 100 basis points.

Commitments for capital expenditures are an important factor in evaluating capital adequacy. During 2011, 2010 and 2009, we invested capital of \$6.0 million, \$10.0 million and \$26.0 million, respectively, into Heartland Community Development Inc., a wholly-owned subsidiary of Heartland. The primary purpose of Heartland Community Development Inc. is to hold and manage certain nonperforming loans and assets to allow the liquidation of such assets at a time that is more economically advantageous. Heartland Community Development Inc. purchased other real estate with a fair value of \$14.6 million, \$7.0 million and \$26.0 million from our Bank Subsidiaries during 2011, 2010 and 2009, respectively. In addition, Heartland Community Development Inc. purchased loans with a fair value of \$3.7 million from a Bank Subsidiary during 2010.

Summit Bank & Trust began operations on November 1, 2006, in the Denver, Colorado suburban community of Broomfield. Our initial investment in this *de novo* was \$12.0 million, which represented 80%, of the \$15.0 million initial capital. The balance was held by minority stockholders under agreements requiring us to repurchase their shares five years from the date of opening at an appraised value, not to exceed 18x earnings, and at a price that represented not less than a 7.66% return on their original investment amount. Rather than accumulate this return, we paid the 7.66% to the minority stockholders annually. Consistent with this agreement, we redeemed the remaining minority interest on October 31, 2011, for \$2.6 million, the initial investment amount contributed by the remaining minority stockholders.

Minnesota Bank & Trust, Heartland's tenth bank, began operations on April 15, 2008, in Edina, Minnesota, located in the Minneapolis, Minnesota, metropolitan area. Our initial investment in this *de novo* was \$13.2 million, or 80%, of the \$16.5 million initial capital. All minority stockholders entered into a stock transfer agreement that imposes certain restrictions on the sale, transfer or other disposition of their shares in Minnesota Bank & Trust and allows, but does not require, us to repurchase the shares from investors.

On December 19, 2008, Heartland received \$81.7 million through participation in the CPP. On September 15, 2011, Heartland sold to the U.S. Treasury \$81.7 million of its Series C Preferred Stock under the SBLF. Simultaneous with receipt of the SBLF funds, Heartland redeemed the \$81.7 million of preferred stock issued to the U.S. Treasury in December 2008 under the CPP. On September 28, 2011, Heartland repurchased a warrant to purchase 609,687 shares of Heartland common stock from the U.S. Treasury that had been issued under the CPP at a purchase price of \$1.8 million. Note 17 to the financial statements contains a detailed discussion about of the capital issuance and redemptions.

We continue to explore opportunities to expand our footprint of independent community banks. Given the current issues in the banking industry, we have changed our strategic growth initiatives from *de novo* banks and branching to acquisitions. Attention will be focused on markets we currently serve, where there would be an opportunity to grow market share, achieve efficiencies and provide greater convenience for current customers. Future expenditures relating to expansion efforts, in addition to those identified above, are not estimable at this time.

## COMMITMENTS AND CONTRACTUAL OBLIGATIONS

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Heartland banks evaluate each customer's creditworthiness on a case-by-

case basis. The amount of collateral obtained, if deemed necessary by the Heartland banks upon extension of credit, is based upon management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment and income-producing commercial properties. Standby letters of credit and financial guarantees written are conditional commitments issued by the Heartland banks to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. At December 31, 2011, and December 31, 2010, commitments to extend credit aggregated \$765.8 million and \$623.2 million, and standby letters of credit aggregated \$49.1 million and \$48.7 million, respectively.

The following table summarizes our significant contractual obligations and other commitments as of December 31, 2011:

## CONTRACTUAL OBLIGATIONS AND OTHER COMMITMENTS

(Dollars in thousands)

|                                 | Total               | Payments Due By Period |                    |                     |                      |
|---------------------------------|---------------------|------------------------|--------------------|---------------------|----------------------|
|                                 |                     | Less than One Year     | One to Three Years | Three to Five Years | More than Five Years |
| <b>Contractual obligations:</b> |                     |                        |                    |                     |                      |
| Time certificates of deposit    | \$ 794,636          | \$ 346,977             | \$ 288,621         | \$ 128,137          | \$ 30,901            |
| Long-term debt obligations      | 372,820             | 66,651                 | 44,914             | 145,914             | 115,341              |
| Operating lease obligations     | 11,934              | 1,440                  | 2,842              | 1,881               | 5,771                |
| Purchase obligations            | 5,073               | 2,286                  | 1,980              | 807                 | —                    |
| Other long-term liabilities     | 2,732               | 138                    | 304                | 304                 | 1,986                |
| Total contractual obligations   | <u>\$ 1,187,195</u> | <u>\$ 417,492</u>      | <u>\$ 338,661</u>  | <u>\$ 277,043</u>   | <u>\$ 153,999</u>    |
|                                 |                     |                        |                    |                     |                      |
| <b>Other commitments:</b>       |                     |                        |                    |                     |                      |
| Lines of credit                 | \$ 765,815          | \$ 645,279             | \$ 83,264          | \$ 22,904           | \$ 14,368            |
| Standby letters of credit       | 49,098              | 35,933                 | 12,587             | 578                 | —                    |
| Total other commitments         | <u>\$ 814,913</u>   | <u>\$ 681,212</u>      | <u>\$ 95,851</u>   | <u>\$ 23,482</u>    | <u>\$ 14,368</u>     |

On a consolidated basis, we maintain a large balance of short-term securities that, when combined with cash from operations, we believe are adequate to meet our funding obligations.

At the parent company level, routine funding requirements consist primarily of dividends paid to stockholders, including the U.S. Treasury under the SBLF, debt service on our revolving credit arrangements and our trust preferred securities issuances, and payments for acquisitions. The parent company obtains the funding to meet these obligations from dividends collected from the Bank Subsidiaries and the issuance of debt securities. At December 31, 2011, Heartland's revolving credit agreements with two unaffiliated banks provided a maximum borrowing capacity of \$10.0 million, none of which had been borrowed. One of these credit agreements contains specific financial covenants which are listed in Note 10 to the consolidated financial statements. At December 31, 2011, Heartland was in compliance with these covenants.

The ability of Heartland to pay dividends to its stockholders is dependent upon dividends paid by its subsidiaries. The Bank Subsidiaries are subject to statutory and regulatory restrictions on the amount they may pay in dividends. To maintain acceptable capital ratios in the Heartland banks, certain portions of their retained earnings are not available for the payment of dividends. Retained earnings that could be available for the payment of dividends to Heartland under the regulatory capital requirements to remain well-capitalized totaled approximately \$77.9 million as of December 31, 2011.

## LIQUIDITY

Liquidity refers to our ability to maintain a cash flow, which is adequate to meet maturing obligations and existing commitments, to withstand fluctuations in deposit levels, to fund operations and to provide for customers' credit needs. The liquidity of Heartland principally depends on cash flows from operating activities, investment in and maturity of assets, changes in balances of deposits and borrowings and its ability to borrow funds in the money or capital markets.

Investing activities used cash of \$192.9 million during 2011 compared to \$159.1 million during 2010 and \$219.8 million during 2009. The proceeds from securities sales, paydowns and maturities were \$789.8 million during 2011 compared to \$654.3 million during 2010 and \$437.0 million during 2009. Purchases of securities used cash of \$788.5 million during 2011 compared to \$738.6 million during 2010 and \$683.4 million during 2009. The net increase in loans and leases used cash of \$207.0 million in 2011 and \$75.6 million in 2010 while the net decrease in loans and leases generated \$8.2 million of cash during 2009.

Financing activities provided cash of \$208.8 million in 2011, used cash of \$41.2 million in 2010 and provided cash of \$311.0 million during 2009. A net increase in deposit accounts provided cash of \$176.1 million in 2011 and a decrease in deposit accounts used cash of \$16.3 million in 2010 whereas an increase in deposit accounts generated \$360.5 million of cash during 2009. Activity in short-term borrowings provided cash of \$34.2 million in 2011, \$73.5 million in 2010 and used cash of \$53.7 million during 2009. Cash proceeds from other borrowings were \$18.6 million during 2011 and \$25.1 million during 2010 as compared to \$55.6 million during 2009. Repayments on other borrowings used cash of \$8.2 million during 2011 as compared to \$114.0 million during 2010 and \$42.0 million during 2009.

Total cash provided by operating activities was \$51.4 million in 2011 compared to \$80.4 million in 2010 and \$39.9 million during 2009. Cash used for the payment of income taxes was \$7.1 million during 2011 compared to \$13.7 million during 2010 and \$7.3 million during 2009.

Management of investing and financing activities, and market conditions, determine the level and the stability of net interest cash flows. Management attempts to mitigate the impact of changes in market interest rates to the extent possible, so that balance sheet growth is the principal determinant of growth in net interest cash flows.

Our short-term borrowing balances are dependent on commercial cash management and smaller correspondent bank relationships and, as such, will normally fluctuate. We believe these balances, on average, to be stable sources of funds; however, we intend to rely on deposit growth and additional FHLB borrowings in the future.

In the event of short-term liquidity needs, the Bank Subsidiaries may purchase federal funds from each other or from correspondent banks and Dubuque Bank and Trust Company may also borrow from the Federal Reserve Bank. Additionally, the Bank Subsidiaries' FHLB memberships give them the ability to borrow funds for short- and long-term purposes under a variety of programs.

At December 31, 2011, Heartland's revolving credit agreements with two unaffiliated banks provided a maximum borrowing capacity of \$10.0 million, of which nothing had been borrowed. These credit agreements contain specific covenants, with which Heartland was in compliance on December 31, 2011.

## **EFFECTS OF INFLATION**

Consolidated financial data included in this report has been prepared in accordance with U.S. generally accepted accounting principles. Presently, these principles require reporting of financial position and operating results in terms of historical dollars, except for available for sale securities, trading securities, derivative instruments, certain impaired loans and other real estate which require reporting at fair value. Changes in the relative value of money due to inflation or recession are generally not considered.

In management's opinion, changes in interest rates affect the financial condition of a financial institution to a far greater degree than changes in the inflation rate. While interest rates are greatly influenced by changes in the inflation rate, they do not change at the same rate or in the same magnitude as the inflation rate. Rather, interest rate volatility is based on changes in the expected rate of inflation, as well as on changes in monetary and fiscal policies. A financial institution's ability to be relatively unaffected by changes in interest rates is a good indicator of its capability to perform in today's volatile economic environment. Heartland seeks to insulate itself from interest rate volatility by ensuring that rate-sensitive assets and rate-sensitive liabilities respond to changes in interest rates in a similar time frame and to a similar degree. See Item 7A of this Form 10-K for a discussion on the process Heartland utilizes to mitigate market risk.

## ITEM 7A.

### QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the risk of loss arising from adverse changes in market prices and rates. Heartland's market risk is comprised primarily of interest rate risk resulting from its core banking activities of lending and deposit gathering. Interest rate risk measures the impact on earnings from changes in interest rates and the effect on current fair market values of Heartland's assets, liabilities and off-balance sheet contracts. The objective is to measure this risk and manage the balance sheet to avoid unacceptable potential for economic loss.

Management continually develops and applies strategies to mitigate market risk. Exposure to market risk is reviewed on a regular basis by the asset/liability committees of the banks and, on a consolidated basis, by Heartland's executive management and board of directors. Darling Consulting Group, Inc. has been engaged to provide asset/liability management position assessment and strategy formulation services to Heartland and its bank subsidiaries. At least quarterly, a detailed review of the balance sheet risk profile is performed for Heartland and each of its bank subsidiaries. Included in these reviews are interest rate sensitivity analyses, which simulate changes in net interest income in response to various interest rate scenarios. This analysis considers current portfolio rates, existing maturities, repricing opportunities and market interest rates, in addition to prepayments and growth under different interest rate assumptions. Selected strategies are modeled prior to implementation to determine their effect on Heartland's interest rate risk profile and net interest income. Management does not believe that Heartland's primary market risk exposures have changed significantly in 2011 when compared to 2010.

The core interest rate risk analysis utilized by Heartland examines the balance sheet under increasing and decreasing interest scenarios that are neither too modest nor too extreme. All rate changes are ramped over a 12-month horizon based upon a parallel shift in the yield curve and then maintained at those levels over the remainder of the simulation horizon. Using this approach, management is able to see the effect that both a gradual change of rates (year 1) and a rate shock (year 2 and beyond) could have on Heartland's net interest income. Starting balances in the model reflect actual balances on the "as of" date, adjusted for material and significant transactions. Pro-forma balances remain static. This enables interest rate risk embedded within the existing balance sheet structure to be isolated from the interest rate risk often caused by growth in assets and liabilities. Due to the low interest rate environment, the simulations under a decreasing interest rate scenario were prepared using a 100 basis point shift in rates. The most recent reviews at December 31, 2011, and 2010, provided the following results:

|                       | 2011                                     |                          | 2010                                     |                          |
|-----------------------|--|--------------------------|--|--------------------------|
|                       | Net Interest<br>Margin<br>(in thousands) | % Change<br>From<br>Base | Net Interest<br>Margin<br>(in thousands) | % Change<br>From<br>Base |
| <b><u>Year 1</u></b>  |  |                          |  |                          |
| Down 100 Basis Points | \$ 140,530                               | 0.01 %                   | \$ 136,979                               | 0.14 %                   |
| Base                  | \$ 140,520                               |                          | \$ 136,786                               |                          |
| Up 200 Basis Points   | \$ 137,316                               | (2.28)%                  | \$ 134,078                               | (1.98)%                  |
| <b><u>Year 2</u></b>  |  |                          |  |                          |
| Down 100 Basis Points | \$ 132,758                               | (5.52)%                  | \$ 130,300                               | (4.74)%                  |
| Base                  | \$ 136,158                               | (3.10)%                  | \$ 134,115                               | (1.95)%                  |
| Up 200 Basis Points   | \$ 138,484                               | (1.45)%                  | \$ 136,107                               | (0.50)%                  |

We use derivative financial instruments to manage the impact of changes in interest rates on our future interest income or interest expense. We are exposed to credit-related losses in the event of nonperformance by the counterparties to these derivative instruments, but believe we have minimized the risk of these losses by entering into the contracts with large, stable financial institutions. The estimated fair market values of these derivative instruments are presented in Note 11 to the consolidated financial statements.

We enter into financial instruments with off balance sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates and may require collateral from the borrower. Standby letters of credit are conditional commitments issued by Heartland to guarantee the performance of a customer to a third party up to a stated amount and with specified terms and conditions. These commitments to extend credit and standby letters of credit are not recorded on the balance sheet until the instrument is exercised.

We hold a securities trading portfolio that would also be subject to elements of market risk. These securities are carried on the balance sheet at fair value. These securities had a carrying value of \$333,000 at December 31, 2011, and \$244,000 at December 31, 2010, and in both cases were less than 1% of total assets.

# ITEM 8.

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

|  | Notes      | December 31,<br>2011 | December 31,<br>2010 |
|--|------------|----------------------|----------------------|
| <b>ASSETS</b>  |            |                      |                      |
| Cash and due from banks  |            | \$ 126,680           | \$ 58,960            |
| Federal funds sold and other short-term investments  | 2          | 3,154                | 3,612                |
| Cash and cash equivalents  |            | 129,834              | 62,572               |
| Securities:  |            |                      |                      |
| Trading, at fair value   |            | 333                  | 244                  |
| Available for sale, at fair value (cost of \$1,242,460 at December 31, 2011, and \$1,188,807 at December 31, 2010)   | 3          | 1,267,999            | 1,204,699            |
| Held to maturity, at cost (fair value of \$57,486 at December 31, 2011, and \$58,610 at December 31, 2010)   | 3          | 58,260               | 59,621               |
| Loans held for sale, net   |            | 53,528               | 23,904               |
| Loans and leases receivable:   | 4          |                      |                      |
| Held to maturity   |            | 2,481,284            | 2,343,987            |
| Loans covered by loss share agreements   |            | 13,347               | 20,800               |
| Allowance for loan and lease losses  | 5          | (36,808)             | (42,693)             |
| Loans and leases receivable, net   |            | 2,457,823            | 2,322,094            |
| Premises, furniture and equipment, net   | 6          | 110,206              | 121,012              |
| Other real estate, net   |            | 44,387               | 32,002               |
| Goodwill   | 7          | 25,909               | 25,909               |
| Other intangible assets, net   | 7          | 12,960               | 13,466               |
| Cash surrender value on life insurance   |            | 67,084               | 62,508               |
| FDIC indemnification asset   |            | 1,343                | 2,294                |
| Other assets   |            | 75,392               | 69,130               |
| <b>TOTAL ASSETS</b>  |            | <b>\$ 4,305,058</b>  | <b>\$ 3,999,455</b>  |
| <b>LIABILITIES AND EQUITY</b>  |            |                      |                      |
| <b>LIABILITIES:</b>  |            |                      |                      |
| Deposits:  | 8          |                      |                      |
| Demand   |            | \$ 737,323           | \$ 580,589           |
| Savings  |            | 1,678,154            | 1,558,998            |
| Time   |            | 794,636              | 894,461              |
| Total deposits   |            | 3,210,113            | 3,034,048            |
| Short-term borrowings  | 9          | 270,081              | 235,864              |
| Other borrowings   | 10         | 372,820              | 362,527              |
| Accrued expenses and other liabilities   |            | 99,151               | 35,232               |
| <b>TOTAL LIABILITIES</b>   |            | <b>3,952,165</b>     | <b>3,667,671</b>     |
| <b>STOCKHOLDERS' EQUITY:</b>   | 15, 16, 17 |                      |                      |
| Preferred stock (par value \$1 per share; authorized 20,604 at December 31, 2011, and 102,302 shares at December 31, 2010; none issued or outstanding)   |            | —                    | —                    |
| Series A Junior Participating preferred stock (par value \$1 per share; authorized 16,000 shares; none issued or outstanding)  |            | —                    | —                    |
| Series B Fixed Rate Cumulative Perpetual preferred stock (par value \$1 per share; liquidation value none at December 31, 2011, and \$81.7 million at December 31, 2010; authorized 81,698 shares; issued and outstanding none at December 31, 2011, and 81,698 shares at December 31, 2010) |            | —                    | 78,483               |
| Series C Fixed Rate Cumulative Perpetual preferred stock (par value \$1 per share; liquidation value \$81.7 million at December 31, 2011, and none at December 31, 2010; authorized, issued and outstanding 81,698 shares at December 31, 2011, and none at December 31, 2010)               |            | 81,698               | —                    |
| Common stock (par value \$1 per share; authorized 25,000,000 shares; issued 16,611,671 shares)   |            | 16,612               | 16,612               |
| Capital surplus  |            | 43,333               | 44,628               |
| Retained earnings  |            | 198,182              | 184,525              |
| Accumulated other comprehensive income   |            | 12,147               | 8,517                |
| Treasury stock at cost (126,881 shares at December 31, 2011, and 186,616 shares at December 31, 2010)  |            | (1,754)              | (3,674)              |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>  |            | <b>350,218</b>       | <b>329,091</b>       |
| Noncontrolling interest  |            | 2,675                | 2,693                |
| <b>TOTAL EQUITY</b>  |            | <b>352,893</b>       | <b>331,784</b>       |
| <b>TOTAL LIABILITIES AND EQUITY</b>  |            | <b>\$ 4,305,058</b>  | <b>\$ 3,999,455</b>  |

See accompanying notes to consolidated financial statements.

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

|   |        | For the Years Ended December 31, |                  |                 |
|---|--------|----------------------------------|------------------|-----------------|
|   | Notes  | 2011                             | 2010             | 2009            |
| <b>INTEREST INCOME:</b>   |        |                                  |                  |                 |
| Interest and fees on loans and leases                                 | 4      | \$ 149,603                       | \$ 151,794       | \$ 154,887      |
| Interest on securities:   |        |                                  |                  |                 |
| Taxable   |        | 28,195                           | 34,507           | 39,782          |
| Nontaxable  |        | 13,935                           | 12,616           | 8,595           |
| Interest on federal funds sold  |        | 3                                | 1                | 2               |
| Interest on interest bearing deposits in other financial institutions |        | 1                                | 14               | 27              |
| <b>TOTAL INTEREST INCOME</b>  |        | <b>191,737</b>                   | <b>198,932</b>   | <b>203,293</b>  |
| <b>INTEREST EXPENSE:</b>  |        |                                  |                  |                 |
| Interest on deposits  | 8      | 29,224                           | 38,272           | 52,744          |
| Interest on short-term borrowings                                     |        | 893                              | 1,160            | 733             |
| Interest on other borrowings  |        | 16,226                           | 16,448           | 17,053          |
| <b>TOTAL INTEREST EXPENSE</b>   |        | <b>46,343</b>                    | <b>55,880</b>    | <b>70,530</b>   |
| <b>NET INTEREST INCOME</b>  |        | <b>145,394</b>                   | <b>143,052</b>   | <b>132,763</b>  |
| Provision for loan and lease losses                                   | 5      | 29,365                           | 32,508           | 39,377          |
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES</b>  |        | <b>116,029</b>                   | <b>110,544</b>   | <b>93,386</b>   |
| <b>NONINTEREST INCOME:</b>  |        |                                  |                  |                 |
| Service charges and fees  |        | 14,303                           | 13,900           | 12,541          |
| Loan servicing income   |        | 5,932                            | 7,232            | 9,666           |
| Trust fees  |        | 9,856                            | 9,206            | 7,773           |
| Brokerage and insurance commissions                                   |        | 3,511                            | 3,184            | 3,117           |
| Securities gains, net   |        | 13,104                           | 6,834            | 8,648           |
| Gain (loss) on trading account securities                             |        | 89                               | (91)             | 211             |
| Impairment loss on equity securities                                  |        | —                                | —                | (40)            |
| Gains on sale of loans held for sale                                  |        | 11,366                           | 8,088            | 6,084           |
| Valuation adjustment on mortgage servicing rights                     |        | (19)                             | —                | —               |
| Income on bank owned life insurance                                   |        | 1,349                            | 1,466            | 1,002           |
| Gain on acquisition   |        | —                                | —                | 1,296           |
| Other noninterest income  |        | 86                               | 2,510            | 2,406           |
| <b>TOTAL NONINTEREST INCOME</b>                                       |        | <b>59,577</b>                    | <b>52,329</b>    | <b>52,704</b>   |
| <b>NONINTEREST EXPENSES:</b>  |        |                                  |                  |                 |
| Salaries and employee benefits  | 13, 15 | 75,537                           | 63,391           | 60,465          |
| Occupancy   | 14     | 9,363                            | 9,121            | 8,992           |
| Furniture and equipment   | 6      | 5,636                            | 6,104            | 6,574           |
| Professional fees   |        | 12,567                           | 10,446           | 9,127           |
| FDIC insurance assessments  |        | 3,777                            | 5,441            | 6,578           |
| Advertising   |        | 4,292                            | 3,830            | 3,337           |
| Intangible assets amortization  | 7      | 572                              | 591              | 866             |
| Goodwill impairment charge  | 7      | —                                | 1,639            | 12,659          |
| Net loss on repossessed assets  |        | 9,807                            | 15,264           | 10,847          |
| Other noninterest expenses  |        | 15,745                           | 13,412           | 13,075          |
| <b>TOTAL NONINTEREST EXPENSES</b>                                     |        | <b>137,296</b>                   | <b>129,239</b>   | <b>132,520</b>  |
| <b>INCOME BEFORE INCOME TAXES</b>                                     |        | <b>38,310</b>                    | <b>33,634</b>    | <b>13,570</b>   |
| Income taxes  | 12     | 10,302                           | 9,846            | 7,196           |
| <b>NET INCOME</b>   |        | <b>28,008</b>                    | <b>23,788</b>    | <b>6,374</b>    |
| Net income available to noncontrolling interest, net of tax           |        | 36                               | 115              | 188             |
| <b>NET INCOME ATTRIBUTABLE TO HEARTLAND</b>                           |        | <b>28,044</b>                    | <b>23,903</b>    | <b>6,562</b>    |
| Preferred dividends and discount                                      |        | (7,640)                          | (5,344)          | (5,344)         |
| <b>NET INCOME AVAILABLE TO COMMON STOCKHOLDERS</b>                    |        | <b>\$ 20,404</b>                 | <b>\$ 18,559</b> | <b>\$ 1,218</b> |
| <b>EARNINGS PER COMMON SHARE - BASIC</b>                              |        | <b>\$ 1.24</b>                   | <b>\$ 1.13</b>   | <b>\$ 0.07</b>  |
| <b>EARNINGS PER COMMON SHARE - DILUTED</b>                            |        | <b>\$ 1.23</b>                   | <b>\$ 1.13</b>   | <b>\$ 0.07</b>  |
| <b>CASH DIVIDENDS DECLARED PER COMMON SHARE</b>                       |        | <b>\$ 0.40</b>                   | <b>\$ 0.40</b>   | <b>\$ 0.40</b>  |

See accompanying notes to consolidated financial statements.

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

|   | For the Years Ended December 31, |                  |                   |
|---|----------------------------------|------------------|-------------------|
|   | 2011                             | 2010             | 2009              |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                                  |                  |                   |
| Net income  | \$ 28,008                        | \$ 23,788        | \$ 6,374          |
| Adjustments to reconcile net income to net cash provided by operating activities:     |                                  |                  |                   |
| Depreciation and amortization   | 7,546                            | 8,366            | 9,036             |
| Provision for loan and lease losses   | 29,365                           | 32,508           | 39,377            |
| Net amortization of premium on securities   | 14,939                           | 7,380            | 2,492             |
| Provision for deferred taxes  | 4,363                            | (2,736)          | (2,599)           |
| Securities gains, net   | (13,104)                         | (6,834)          | (8,648)           |
| (Increase) decrease in trading account securities                                     | (89)                             | 451              | 795               |
| Loss on impairment of equity securities   | —                                | —                | 40                |
| Stock based compensation  | 1,278                            | 926              | 953               |
| Loans originated for sale   | (479,221)                        | (639,381)        | (805,250)         |
| Proceeds on sales of loans  | 460,963                          | 654,063          | 808,949           |
| Net gains on sales of loans   | (11,366)                         | (8,088)          | (6,084)           |
| (Increase) decrease in accrued interest receivable                                    | 1,397                            | 1,097            | (933)             |
| (Increase) decrease in prepaid expenses   | 2,969                            | 2,459            | (17,979)          |
| Decrease in accrued interest payable  | (701)                            | (1,056)          | (2,564)           |
| Goodwill impairment charge  | —                                | 1,639            | 12,659            |
| Valuation adjustment on mortgage servicing rights                                     | 19                               | —                | —                 |
| Gain on acquisition   | —                                | —                | (1,296)           |
| Other, net  | 5,039                            | 5,856            | 4,559             |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                                      | <b>51,405</b>                    | <b>80,438</b>    | <b>39,881</b>     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                                  |                  |                   |
| Proceeds from the sale of securities available for sale                               | 493,167                          | 399,901          | 198,086           |
| Proceeds from the sale of securities held to maturity                                 | —                                | —                | 1,659             |
| Proceeds from the maturity of and principal paydowns on securities available for sale | 295,137                          | 252,514          | 234,640           |
| Proceeds from the maturity of and principal paydowns on securities held to maturity   | 1,461                            | 1,913            | 2,592             |
| Purchase of securities available for sale   | (788,543)                        | (715,164)        | (670,493)         |
| Purchase of securities held to maturity   | —                                | (23,419)         | (12,895)          |
| Net (increase) decrease in loans and leases   | (207,027)                        | (75,583)         | 8,156             |
| Purchase of bank owned life insurance policies  | (3,140)                          | (5,676)          | —                 |
| Capital expenditures  | (6,719)                          | (9,605)          | (6,596)           |
| Net cash and cash equivalents received in acquisition, net of cash paid               | —                                | —                | 7,193             |
| Proceeds on sale of OREO and other repossessed assets                                 | 22,771                           | 16,001           | 17,871            |
| <b>NET CASH USED BY INVESTING ACTIVITIES</b>  | <b>(192,893)</b>                 | <b>(159,118)</b> | <b>(219,787)</b>  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |                                  |                  |                   |
| Net increase in demand deposits and savings accounts                                  | 275,890                          | 124,584          | 475,702           |
| Net decrease in time deposit accounts   | (99,825)                         | (140,925)        | (115,192)         |
| Net increase (decrease) in short-term borrowings                                      | 34,217                           | 73,515           | (53,663)          |
| Proceeds from other borrowings  | 18,565                           | 25,075           | 55,552            |
| Repayments of other borrowings  | (8,272)                          | (113,977)        | (41,956)          |
| Proceeds from issuance of preferred stock   | 81,698                           | —                | —                 |
| Redemption of preferred stock   | (81,698)                         | —                | —                 |
| Redemption of Warrant   | (1,800)                          | —                | —                 |
| Purchase of treasury stock  | (389)                            | (212)            | (236)             |
| Proceeds from issuance of common stock  | 1,428                            | 1,360            | 970               |
| Excess tax benefits on exercised stock options  | 108                              | 28               | 18                |
| Dividends paid  | (11,172)                         | (10,606)         | (10,182)          |
| <b>NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES</b>                               | <b>208,750</b>                   | <b>(41,158)</b>  | <b>311,013</b>    |
| Net increase (decrease) in cash and cash equivalents                                  | 67,262                           | (119,838)        | 131,107           |
| Cash and cash equivalents at beginning of year  | 62,572                           | 182,410          | 51,303            |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>                                     | <b>\$ 129,834</b>                | <b>\$ 62,572</b> | <b>\$ 182,410</b> |
| Supplemental disclosures:   |                                  |                  |                   |
| Cash paid for income/franchise taxes  | \$ 7,133                         | \$ 13,676        | \$ 7,269          |
| Cash paid for interest  | \$ 47,044                        | \$ 56,936        | \$ 73,094         |
| Loans transferred to OREO and other repossessed assets                                | \$ 41,933                        | \$ 28,947        | \$ 43,231         |
| Purchases of securities available for sale, accrued, not paid                         | \$ 55,349                        | \$ —             | \$ —              |

See accompanying notes to consolidated financial statements.



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

|   | Heartland Financial USA, Inc. Stockholders' Equity |                  |                  |                   |   |                   |                          | Total Equity      |
|---|--|------------------|------------------|-------------------|---|-------------------|--------------------------|-------------------|
|   | Preferred Stock                                    | Common Stock     | Capital Surplus  | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock    | Non-controlling Interest |                   |
| Balance at January 1, 2009  | \$ 75,578  | \$ 16,612        | \$ 43,827        | \$ 177,753        | \$ (1,341)                                    | \$ (6,826)        | \$ 3,020                 | \$ 308,623        |
| Net income  |  |                  |                  | 6,562             |   |                   | (188)                    | 6,374             |
| Unrealized gain (loss) on securities available for sale arising during the period     |  |                  |                  |                   | 21,868  |                   |                          | 21,868            |
| Unrealized gain (loss) on derivatives arising during the period                       |  |                  |                  |                   | (41)  |                   |                          | (41)              |
| Reclassification adjustment for net security (gains)/losses realized in net income    |  |                  |                  |                   | (8,608)                                       |                   |                          | (8,608)           |
| Reclassification adjustment for net derivatives (gains)/losses realized in net income |  |                  |                  |                   | 196   |                   |                          | 196               |
| Income taxes  |  |                  |                  |                   | (4,967)                                       |                   |                          | (4,967)           |
| Comprehensive income  |  |                  |                  |                   |   |                   |                          | 14,822            |
| Purchase of noncontrolling interest   |  |                  |                  |                   |   |                   | (56)                     | (56)              |
| Cumulative preferred dividends accrued and discount accretion                         | 1,646  |                  |                  | (1,646)           |   |                   |                          | —                 |
| Cash dividends declared:  |  |                  |                  |                   |   |                   |                          |                   |
| Preferred, \$50.00 per share  |  |                  |                  | (3,698)           |   |                   |                          | (3,698)           |
| Common, \$0.40 per share  |  |                  |                  | (6,484)           |   |                   |                          | (6,484)           |
| Purchase of 16,021 shares of common stock   |  |                  |                  |                   |   | (236)             |                          | (236)             |
| Issuance of 87,893 shares of common stock   |  |                  | (496)            |                   |   | 1,629             |                          | 1,133             |
| Commitments to issue common stock   |  |                  | 953              |                   |   |                   |                          | 953               |
| <b>Balance at December 31, 2009</b>   | <b>\$ 77,224</b>                                   | <b>\$ 16,612</b> | <b>\$ 44,284</b> | <b>\$ 172,487</b> | <b>\$ 7,107</b>                               | <b>\$ (5,433)</b> | <b>\$ 2,776</b>          | <b>\$ 315,057</b> |
| <b>Balance at January 1, 2010</b>   | <b>\$ 77,224</b>                                   | <b>\$ 16,612</b> | <b>\$ 44,284</b> | <b>\$ 172,487</b> | <b>\$ 7,107</b>                               | <b>\$ (5,433)</b> | <b>\$ 2,776</b>          | <b>\$ 315,057</b> |
| Net income  |  |                  |                  | 23,903            |   |                   | (115)                    | 23,788            |
| Unrealized gain (loss) on securities available for sale arising during the period     |  |                  |                  |                   | 12,923  |                   |                          | 12,923            |
| Unrealized gain (loss) on derivatives arising during the period                       |  |                  |                  |                   | (4,652)                                       |                   |                          | (4,652)           |
| Reclassification adjustment for net security (gains)/losses realized in net income    |  |                  |                  |                   | (6,834)                                       |                   |                          | (6,834)           |
| Reclassification adjustment for net derivatives (gains)/losses realized in net income |  |                  |                  |                   | 726   |                   |                          | 726               |
| Income taxes  |  |                  |                  |                   | (753)   |                   |                          | (753)             |
| Comprehensive income  |  |                  |                  |                   |   |                   |                          | 25,198            |
| Sale of noncontrolling interest   |  |                  |                  |                   |   |                   | 32                       | 32                |
| Cumulative preferred dividends accrued and discount accretion                         | 1,259  |                  |                  | (1,259)           |   |                   |                          | —                 |
| Cash dividends declared:  |  |                  |                  |                   |   |                   |                          |                   |
| Preferred, \$50.00 per share  |  |                  |                  | (4,085)           |   |                   |                          | (4,085)           |
| Common, \$0.40 per share  |  |                  |                  | (6,521)           |   |                   |                          | (6,521)           |
| Purchase of 14,420 shares of common stock   |  |                  |                  |                   |   | (211)             |                          | (211)             |
| Issuance of 93,113 shares of common stock   |  |                  | (582)            |                   |   | 1,970             |                          | 1,388             |
| Commitments to issue common stock   |  |                  | 926              |                   |   |                   |                          | 926               |
| <b>Balance at December 31, 2010</b>   | <b>\$ 78,483</b>                                   | <b>\$ 16,612</b> | <b>\$ 44,628</b> | <b>\$ 184,525</b> | <b>\$ 8,517</b>                               | <b>\$ (3,674)</b> | <b>\$ 2,693</b>          | <b>\$ 331,784</b> |

See accompanying notes to consolidated financial statements.

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

|   | Heartland Financial USA, Inc. Stockholders' Equity |                  |                  |                   |   |                   |                          | Total Equity      |
|---|--|------------------|------------------|-------------------|---|-------------------|--------------------------|-------------------|
|   | Preferred Stock                                    | Common Stock     | Capital Surplus  | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock    | Non-controlling Interest |                   |
| <b>Balance at January 1, 2011</b>   | \$ 78,483  | \$ 16,612        | \$ 44,628        | \$ 184,525        | \$ 8,517                                      | \$ (3,674)        | \$ 2,693                 | \$ 331,784        |
| Net income  |  |                  |                  | 28,044            |   |                   | (36)                     | 28,008            |
| Unrealized gain (loss) on securities available for sale arising during the period     |  |                  |                  |                   | 22,751  |                   |                          | 22,751            |
| Unrealized gain (loss) on derivatives arising during the period                       |  |                  |                  |                   | (5,827)                                       |                   |                          | (5,827)           |
| Reclassification adjustment for net security (gains)/losses realized in net income    |  |                  |                  |                   | (13,104)                                      |                   |                          | (13,104)          |
| Reclassification adjustment for net derivatives (gains)/losses realized in net income |  |                  |                  |                   | 1,996   |                   |                          | 1,996             |
| Income taxes  |  |                  |                  |                   | (2,186)                                       |                   |                          | (2,186)           |
| Comprehensive income  |  |                  |                  |                   |   |                   |                          | 31,638            |
| Sale of noncontrolling interest   |  |                  |                  |                   |   |                   | 18                       | 18                |
| Cumulative preferred dividends accrued and discount accretion                         | 3,215  |                  |                  | (3,215)           |   |                   |                          | —                 |
| Repurchase of Series B preferred stock and Warrant                                    | (81,698)   |                  | (1,800)          |                   |   |                   |                          | (83,498)          |
| Issuance of Series C preferred stock  | 81,698   |                  |                  |                   |   |                   |                          | 81,698            |
| Cash dividends declared:  |  |                  |                  |                   |   |                   |                          |                   |
| Preferred, \$50.00 per share  |  |                  |                  | (4,606)           |   |                   |                          | (4,606)           |
| Common, \$0.40 per share  |  |                  |                  | (6,566)           |   |                   |                          | (6,566)           |
| Purchase of 54,723 shares of common stock   |  |                  |                  |                   |   | (389)             |                          | (389)             |
| Issuance of 114,458 shares of common stock  |  |                  | (773)            |                   |   | 2,309             |                          | 1,536             |
| Commitments to issue common stock   |  |                  | 1,278            |                   |   |                   |                          | 1,278             |
| <b>Balance at December 31, 2011</b>   | <u>\$ 81,698</u>                                   | <u>\$ 16,612</u> | <u>\$ 43,333</u> | <u>\$ 198,182</u> | <u>\$ 12,147</u>                              | <u>\$ (1,754)</u> | <u>\$ 2,675</u>          | <u>\$ 352,893</u> |

See accompanying notes to consolidated financial statements.

**HEARTLAND FINANCIAL USA, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**ONE**  
**SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Nature of Operations** - Heartland Financial USA, Inc. ("Heartland") is a multi-bank holding company primarily operating full-service banking offices serving communities in and around Dubuque and Lee Counties in Iowa; Jo Daviess, Hancock and Winnebago Counties in Illinois; Dane, Green, Sheboygan and Brown Counties in Wisconsin; Bernalillo, Curry and Santa Fe Counties in New Mexico; Maricopa County in Arizona; Flathead, Gallatin, Jefferson, Ravalli, Sanders, Sheridan and Yellowstone Counties in Montana; Broomfield, Adams and Boulder Counties in Colorado; and Hennepin County in Minnesota. The principal services of Heartland, through its subsidiaries, are FDIC-insured deposit accounts and related services, and loans to businesses and individuals. The loans consist primarily of commercial and commercial real estate, agricultural and agricultural real estate and residential real estate.

**Principles of Presentation** - The consolidated financial statements include the accounts of Heartland and its subsidiaries: Dubuque Bank and Trust Company; Galena State Bank & Trust Co.; Riverside Community Bank; Wisconsin Community Bank; New Mexico Bank & Trust; Arizona Bank & Trust; Rocky Mountain Bank; Summit Bank & Trust; Minnesota Bank & Trust; Citizens Finance Co.; DB&T Insurance, Inc.; DB&T Community Development Corp.; Heartland Community Development, Inc.; Heartland Financial Statutory Trust III; Heartland Financial Statutory Trust IV; Heartland Financial Statutory Trust V; Heartland Financial Statutory Trust VI; Heartland Financial Statutory Trust VII; and Rocky Mountain Statutory Trust I. All of Heartland's subsidiaries are wholly-owned except for Minnesota Bank & Trust, of which Heartland was an 80% owner on December 31, 2011. Heartland combined its First Community Bank charter with its Dubuque Bank and Trust Company charter in 2011. All significant intercompany balances and transactions have been eliminated in consolidation. The noncontrolling interest in the majority-owned subsidiaries is noted on the consolidated balance sheets and on the consolidated statements of income.

The consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles and prevailing practices within the banking industry. In preparing such financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ significantly from those estimates. A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for loan and lease losses.

Heartland and its subsidiaries operate primarily in one segment, banking, which constitutes most of its consolidated results of operations and assets. Accordingly, the results of operations and assets for separate business segments are not presented.

**Cash and Cash Equivalents** - For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and other short-term investments. Generally, federal funds are purchased and sold for one-day periods.

**Trading Securities** - Trading securities represent those securities Heartland intends to actively trade and are stated at fair value with changes in fair value reflected in noninterest income.

**Securities Available for Sale** - Available for sale securities consist of those securities not classified as held to maturity or trading, which management intends to hold for indefinite periods of time or that may be sold in response to changes in interest rates, prepayments or other similar factors. Available for sale securities are stated at fair value with any unrealized gain or loss, net of applicable income tax, reported as a separate component of stockholders' equity. Security premiums and discounts are amortized/accreted using the interest method over the period from the purchase date to the expected maturity or call date of the related security. Declines in the fair value of investment securities available for sale (with certain exceptions for debt securities noted below) that are deemed to be other-than-temporary are charged to earnings as a realized loss, and a new cost basis for the securities is established. In evaluating other-than-temporary impairment, Heartland considers the length of time and extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of Heartland to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value in the near term. Declines in the fair value of debt securities below amortized cost are deemed to be other-than-temporary in circumstances where: (1) Heartland has the intent to sell a security; (2) it is more likely than not that Heartland will be required to sell the security before recovery of its amortized cost basis; or (3) Heartland does not expect to recover the entire amortized cost basis of the security. If Heartland intends to sell a security or if it is more likely than not that Heartland will be required to sell the security before recovery, an other-than-temporary impairment write-down is recognized in earnings equal to the difference between the

security's amortized cost basis and its fair value. If Heartland does not intend to sell the security or it is not more likely than not that it will be required to sell the security before recovery, the other-than-temporary impairment write-down is separated into an amount representing credit loss, which is recognized in earnings, and an amount related to all other factors, which is recognized in other comprehensive income. Realized securities gains or losses on securities sales (using specific identification method) and declines in value judged to be other than temporary are included in investment securities gains, net, in the consolidated statements of income.

***Securities Held to Maturity*** - Securities which Heartland has the ability and positive intent to hold to maturity are classified as held to maturity. Such securities are stated at amortized cost, adjusted for premiums and discounts that are amortized/accreted using the interest method over the period from the purchase date to the expected maturity or call date of the related security. Unrealized losses determined to be other than temporary are charged to noninterest income.

***Loans and Leases*** - Interest on loans is accrued and credited to income based primarily on the principal balance outstanding. Income from leases is recorded in decreasing amounts over the term of the contract resulting in a level rate of return on the lease investment. 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 policies, all nonaccrual and restructured loans meeting the criteria of a troubled debt restructuring are defined as impaired loans. 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.

Net nonrefundable loan and lease origination fees and certain direct costs associated with the lending process are deferred and recognized as a yield adjustment over the life of the related loan or lease.

***Loans Held for Sale*** - Loans held for sale are stated at the lower of cost or fair value on an aggregate basis. Gains or losses on sales are recorded in noninterest income. Direct loan origination costs and fees are deferred at origination of the loan. These deferred costs and fees are recognized in noninterest income as part of the gain or loss on sales of loans upon sale of the loan.

***Mortgage Servicing and Transfers of Financial Assets*** - Heartland regularly sells residential mortgage loans to others on a non-recourse basis. Sold loans are not included in the accompanying consolidated balance sheets. Heartland generally retains the right to service the sold loans for a fee. At December 31, 2011 and 2010, Heartland was servicing loans for others with aggregate unpaid principal balances of \$1.54 billion and \$1.40 billion, respectively.

***Allowance for Loan and Lease Losses*** - The allowance for loan and lease losses is maintained at a level estimated by management to provide for known and inherent risks in the loan and lease portfolios. The allowance is based upon a continuing review of past loan and lease loss experience, current economic conditions, volume growth, the underlying collateral value of the loans and leases and other relevant factors. Loans and leases which are deemed uncollectible are charged off and deducted from the allowance. Provisions for loan and lease losses and recoveries on previously charged-off loans and leases are added to the allowance.

***Reserve for Unfunded Commitments*** - This reserve is maintained at a level that, in the opinion of management, is adequate to absorb probable losses associated with Heartland's commitment to lend funds under existing agreements such as letters or lines of credit. Management determines the adequacy of the reserve for unfunded commitments based upon reviews of delinquencies, current economic conditions, the risk characteristics of the various categories of commitments and other relevant factors. The reserve is based on estimates, and ultimate losses may vary from the current estimates. These estimates are evaluated on a regular basis and, as adjustments become necessary, they are reported in earnings in the periods in which they become known. Draws on unfunded commitments that are considered uncollectible at the time funds are advanced are charged to the allowance. Provisions for unfunded commitment losses are added to the reserve for unfunded commitments, which is included in the Other Liabilities section of the consolidated balance sheets.

**Premises, Furniture and Equipment** - Premises, furniture and equipment are stated at cost less accumulated depreciation. The provision for depreciation of premises, furniture and equipment is determined by straight-line and accelerated methods over the estimated useful lives of 18 to 39 years for buildings, 15 years for land improvements and 3 to 7 years for furniture and equipment.

**Other Real Estate** - Other real estate represents property acquired through foreclosures and settlements of loans. Property acquired is carried at the lower of the principal amount of the loan outstanding at the time of acquisition, plus any acquisition costs, or the estimated fair value of the property, less disposal costs. The excess, if any, of such costs at the time acquired over the fair value is charged against the allowance for loan and lease losses. Subsequent write downs estimated on the basis of later valuations, gains or losses on sales and net expenses incurred in maintaining such properties are charged to other noninterest expense.

**Goodwill and Intangible Assets** - Intangible assets consist of goodwill, core deposit premiums, customer relationship intangibles and mortgage servicing rights. Goodwill represents the excess of the purchase price of acquired subsidiaries' net assets over their fair value. Heartland assesses goodwill for impairment annually, and more frequently if events occur which may indicate possible impairment, and assesses goodwill at the reporting unit level, also giving consideration to overall enterprise value as part of that assessment. Goodwill impairment is determined using a two-step process. In the first step, the fair value of a reporting unit is compared to its carrying amount, including goodwill. If the fair value of the reporting unit exceeds its carrying amount, goodwill is not considered impaired and it is not necessary to continue to step two of the impairment process. If the fair value of the reporting unit is less than the carrying amount, step two is performed. In step two, the implied fair value of goodwill is compared to the carrying value of the reporting units' goodwill. The implied fair value of goodwill is computed as a residual value after allocating the fair value of the reporting unit to its assets and liabilities. Heartland estimates the fair value of its reporting units using market multiples of comparable entities, including recent transactions, or a combination of market multiples and discounted cash flow methodology. These methods incorporate assumptions specific to the entity, such as the use of financial forecasts.

Core deposit premiums are amortized over eight to eighteen years on an accelerated basis. Customer relationship intangibles are amortized over 22 years on an accelerated basis. Periodically, Heartland reviews the intangible assets for events or circumstances that may indicate a change in the recoverability of the underlying basis, except mortgage servicing rights which are reviewed quarterly.

Mortgage servicing rights associated with loans originated and sold, where servicing is retained, are initially capitalized at fair value and recorded on the consolidated statements of income as loan servicing income. The values of these capitalized servicing rights are amortized as an offset to the servicing revenue earned in relation to the servicing revenue expected to be earned. The carrying values of these rights are reviewed quarterly for impairment based on the calculation of their fair value as performed by an outside third party. For purposes of measuring impairment, the rights are stratified into certain risk characteristics including loan type, note rate, prepayment trends and external market factors. A valuation allowance of \$19,000 was required as of December 31, 2011 and no valuation allowance was required as of December 31, 2010.

**Bank-Owned Life Insurance** - Heartland and its subsidiaries have purchased life insurance policies on the lives of certain officers. The one-time premiums paid for the policies, which coincide with the initial cash surrender value, are recorded as an asset. Increases or decreases in the cash surrender value, other than proceeds from death benefits, are recorded as noninterest income (loss). Proceeds from death benefits first reduce the cash surrender value attributable to the individual policy and then any additional proceeds are recorded as noninterest income.

**Income Taxes** - Heartland and its subsidiaries file a consolidated federal income tax return and separate or combined income or franchise tax returns as required by the various states. Heartland has a tax allocation agreement which provides that each subsidiary of the consolidated group pays a tax liability to, or receives a tax refund from Heartland, computed as if the subsidiary had filed a separate return.

Heartland recognizes certain income and expenses in different time periods for financial reporting and income tax purposes. The provision for deferred income taxes is based on an asset and liability approach and represents the change in deferred income tax accounts during the year, including the effect of enacted tax rate changes. A valuation allowance is provided to reduce deferred tax assets if their expected realization is deemed not to be more likely than not.

**Derivative Financial Instruments** - Heartland uses derivative financial instruments as part of its interest rate risk management, including interest rate swaps, caps, floors, collars and certain interest rate lock commitments and forward sales of securities related to mortgage banking activities. FASB Accounting Standards Topic 815 establishes accounting and reporting standards

for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. As required by ASC 815, Heartland records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives used to hedge the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. To qualify for hedge accounting, Heartland must comply with the detailed rules and documentation requirements at the inception of the hedge, and hedge effectiveness is assessed at inception and periodically throughout the life of each hedging relationship. Hedge ineffectiveness, if any, is measured periodically throughout the life of the hedging relationship.

For derivatives designated as cash flow hedges, the effective portion of changes in the fair value of the derivative is initially reported in other comprehensive income and subsequently reclassified to interest income or expense when the hedged transaction affects earnings, while the ineffective portion of changes in the fair value of the derivative, if any, is recognized immediately in other noninterest income. Heartland assesses the effectiveness of each hedging relationship by comparing the cumulative changes in cash flows of the derivative hedging instrument with the cumulative changes in cash flows of the designated hedged item or transaction. No component of the change in the fair value of the hedging instrument is excluded from the assessment of hedge effectiveness.

Heartland had no fair value hedging relationships at December 31, 2011 or 2010. Derivatives not qualifying for hedge accounting, classified as free-standing derivatives, have all changes in the fair value recorded on the income statement through noninterest income.

Heartland does not use derivatives for trading or speculative purposes. Derivatives not designated as hedges are not speculative and are used to manage Heartland's exposure to interest rate movements and other identified risks, but do not meet the strict hedge accounting requirements of ASC 815.

**Treasury Stock** - Treasury stock is accounted for by the cost method, whereby shares of common stock reacquired are recorded at their purchase price. When treasury stock is reissued, any difference between the sales proceeds, or fair value when issued for business combinations, and the cost is recognized as a charge or credit to capital surplus.

**Trust Department Assets** - Property held for customers in fiduciary or agency capacities is not included in the accompanying consolidated balance sheets, as such items are not assets of the Heartland banks.

**Earnings Per Share** - Amounts used in the determination of basic and diluted earnings per share for the years ended December 31, 2011, 2010, and 2009 are shown in the table below:

(Dollars and number of shares in thousands)

|   | 2011      | 2010      | 2009     |
|---|-----------|-----------|----------|
| Net income  | \$ 28,008 | \$ 23,788 | \$ 6,374 |
| Net income attributable to noncontrolling interest, net of tax                            | 36        | 115       | 188      |
| Net income attributable to Heartland  | 28,044    | 23,903    | 6,562    |
| Preferred dividends and discount  | (7,640)   | (5,344)   | (5,344)  |
| Net income available to common stockholders   | \$ 20,404 | \$ 18,559 | \$ 1,218 |
| Weighted average common shares outstanding for basic earnings per share                   | 16,437    | 16,372    | 16,304   |
| Assumed incremental common shares issued upon exercise of stock options                   | 139       | 90        | 21       |
| Weighted average common shares for diluted earnings per share                             | 16,576    | 16,462    | 16,325   |
| Earnings per common share-basic   | \$ 1.24   | \$ 1.13   | \$ 0.07  |
| Earnings per common share-diluted   | 1.23      | 1.13      | 0.07     |
| Number of antidilutive stock options excluded from diluted earnings per share computation | 514       | 562       | 573      |

**Effect of New Financial Accounting Standards** - In January 2010, the FASB issued an accounting standard which requires (i) fair value disclosures by each class of assets and liabilities (generally a subset within a line item as presented in the statement of financial position) rather than major category, (ii) for items measured at fair value on a recurring basis, the amounts of significant transfers between Levels 1 and 2, and transfers into and out of Level 3, and the reasons for those transfers, including separate discussion related to the transfers into each level apart from transfers out of each level, and (iii) gross presentation of the amounts of purchases, sales, issuances and settlements in the Level 3 recurring measurement reconciliation. Additionally,

the standard clarifies that a description of the valuation techniques(s) and inputs used to measure fair values is required for both recurring and nonrecurring fair value measurements. Also, if a valuation technique has changed, entities should disclose that change and the reason for the changes. Disclosures other than the gross presentation changes in the Level 3 reconciliation were effective for the first reporting period beginning after December 31, 2009. Heartland adopted this accounting standard at the beginning of 2010, except for the detailed Level 3 disclosures, with no material impact on the results of operations, financial position and liquidity. Heartland adopted the presentment of detailed Level 3 disclosures during the first quarter of 2011 with no material impact on the results of operations, financial position and liquidity.

In July 2010, the FASB issued ASU No. 2010-20, *"Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses,"* which requires significant new disclosures about the allowance for credit losses and the credit quality of financing receivables. The requirements are intended to enhance transparency regarding credit losses and the credit quality of loan and lease receivables. Under this statement, the activity in the allowance for credit losses and recorded investment in financing receivables are to be disclosed by portfolio segment, while credit quality information, impaired financing receivables and nonaccrual status are to be presented by class of financing receivable. Disclosure of the nature and extent, the financial impact and segment information of troubled debt restructurings ("TDRs") is also required. The disclosures are to be presented at the level of disaggregation that management uses when assessing and monitoring the portfolio's risk and performance. Heartland adopted this accounting standard as of December 31, 2010, except for the activity-related disclosures, with no material impact on the results of operations, financial position and liquidity. Heartland adopted the activity-related disclosures during the first quarter of 2011 with no material impact on the results of operations, financial position and liquidity. Heartland adopted the disclosure requirements related to the TDRs effective July 1, 2011, with no material impact on the results of operations, financial position and liquidity. See Note 4 for additional disclosures regarding this accounting standard.

In April 2011, the FASB issued ASU No. 2011-02, *"A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring,"* which modifies guidance for identifying restructurings of receivables that constitute a TDR. This standard requires retrospective application to all restructurings occurring during 2011, along with disclosure of certain additional information. Heartland adopted this guidance effective July 1, 2011, with no significant impact to the restructurings that are considered TDRs and the related allowance for loan losses required for these loans.

In April 2011, the FASB issued ASU No. 2011-03, *"Reconsideration of Effective Control for Repurchase Agreements,"* which removes the collateral maintenance provision that is currently required when determining whether a transfer of a financial instrument is accounted for as a sale or a secured borrowing. The adoption of this accounting standard will be required for Heartland's first quarter 2012 Form 10-Q and is not expected to have a material impact on the results of operations, financial position and liquidity.

In May 2011, the FASB issued ASU No. 2011-04, *"Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS,"* which is a joint effort between the FASB and IASB to converge fair value measurement and disclosure guidance. This standard permits measuring financial assets and liabilities on a net credit risk basis, if certain criteria are met. This standard also increases disclosure surrounding company-determined market prices (Level 3) financial instruments and requires the fair value hierarchy disclosure of financial assets and liabilities that are not recognized at fair value in the statement of financial position for which fair values are disclosed. The adoption of this accounting standard will be required for Heartland's first quarter 2012 Form 10-Q, and is not expected to have a material impact on the results of operations, financial position and liquidity.

In June 2011, the FASB issued ASU No. 2011-05, *"Presentation of Comprehensive Income,"* which requires companies to report total net income, each component of comprehensive income, and total comprehensive income on the face of the income statement, or as two consecutive statements. The components of comprehensive income will not be changed, nor does the standard affect how earnings per share is calculated or reported. These amendments will be reported retrospectively upon adoption. The adoption of this standard will be required for Heartland's first quarter 2012 Form 10-Q, and is not expected to have a material impact on the results of operations, financial position and liquidity. In December 2011, the FASB issued ASU No. 2011-12, *"Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05."* This standard indefinitely defers the requirements of ASU No. 2011-05 that relate to the presentation of classification adjustments. This ASU does not affect any other requirements of ASU No. 2011-05.

In September 2011, the FASB issued ASU No. 2011-08, *"Intangibles-Goodwill and Other (Topic 350): Testing Goodwill for Impairment,"* which allows an entity to make an initial qualitative evaluation as to whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. The results of this qualitative assessment determine if it is necessary to perform the currently required two-step impairment test. ASU 2011-08 also expands upon the examples of events

and circumstances that an entity should consider between annual impairment tests in determining if it is more likely than not that the fair value of a reporting unit is less than its carrying amount. The new guidance is effective for fiscal years beginning after December 15, 2011, with early adoption permitted. Heartland anticipates that the adoption of this standard will not have a material impact on the results of operations, financial position and liquidity.

## TWO

### CASH AND DUE FROM BANKS

The Heartland banks are required to maintain certain average cash reserve balances as a non-member bank of the Federal Reserve System. The reserve balance requirements at December 31, 2011 and 2010, were \$7.7 million and \$7.3 million, respectively.

## THREE

### SECURITIES

The amortized cost, gross unrealized gains and losses and estimated fair values of available for sale securities as of December 31, 2011 and 2010, are summarized as follows:

(Dollars in thousands)

|  | Amortized<br>Cost   | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value |
|--|---------------------|------------------------------|-------------------------------|-------------------------|
| <b>2011</b>                                      |                     |                              |                               |                         |
| <b>Securities available for sale:</b>            |                     |                              |                               |                         |
| U.S. government corporations and agencies        | \$ 104,719          | \$ 2,428                     | \$ —                          | \$ 107,147              |
| Mortgage-backed securities                       | 815,408             | 14,643                       | (4,997)                       | 825,054                 |
| Obligations of states and political subdivisions | 272,660             | 14,983                       | (973)                         | 286,670                 |
| Corporate debt securities                        | 26,284              | 29                           | (1,060)                       | 25,253                  |
| Total debt securities                            | 1,219,071           | 32,083                       | (7,030)                       | 1,244,124               |
| Equity securities                                | 23,389              | 486                          | —                             | 23,875                  |
| Total  | <u>\$ 1,242,460</u> | <u>\$ 32,569</u>             | <u>\$ (7,030)</u>             | <u>\$ 1,267,999</u>     |
| <b>2010</b>                                      |                     |                              |                               |                         |
| <b>Securities available for sale:</b>            |                     |                              |                               |                         |
| U.S. government corporations and agencies        | \$ 316,758          | \$ 4,392                     | \$ (1,143)                    | \$ 320,007              |
| Mortgage-backed securities                       | 586,796             | 17,455                       | (4,211)                       | 600,040                 |
| Obligations of states and political subdivisions | 244,368             | 4,235                        | (4,140)                       | 244,463                 |
| Corporate debt securities                        | 16,142              | —                            | (1,168)                       | 14,974                  |
| Total debt securities                            | 1,164,064           | 26,082                       | (10,662)                      | 1,179,484               |
| Equity securities                                | 24,743              | 472                          | —                             | 25,215                  |
| Total  | <u>\$ 1,188,807</u> | <u>\$ 26,554</u>             | <u>\$ (10,662)</u>            | <u>\$ 1,204,699</u>     |



The amortized cost, gross unrealized gains and losses and estimated fair values of held to maturity securities as of December 31, 2011 and 2010, are summarized as follows:

(Dollars in thousands)

|  | <u>Amortized<br/>Cost</u> | <u>Gross<br/>Unrealized<br/>Gains</u> | <u>Gross<br/>Unrealized<br/>Losses</u> | <u>Estimated<br/>Fair Value</u> |
|--|---------------------------|---------------------------------------|--|---------------------------------|
| <b>2011</b>                                      |                           |                                       |  |                                 |
| <b>Securities held to maturity:</b>              |                           |                                       |  |                                 |
| Mortgage-backed securities                       | \$ 9,131                  | \$ 40                                 | \$ (1,532)                             | \$ 7,639                        |
| Obligations of states and political subdivisions | 49,129                    | 730                                   | (12)                                   | 49,847                          |
| <b>Total</b>                                     | <u>\$ 58,260</u>          | <u>\$ 770</u>                         | <u>\$ (1,544)</u>                      | <u>\$ 57,486</u>                |
| <b>2010</b>                                      |                           |                                       |  |                                 |
| <b>Securities held to maturity:</b>              |                           |                                       |  |                                 |
| Mortgage-backed securities                       | \$ 9,825                  | \$ 145                                | \$ (993)                               | \$ 8,977                        |
| Obligations of states and political subdivisions | 49,796                    | —                                     | (163)                                  | 49,633                          |
| <b>Total</b>                                     | <u>\$ 59,621</u>          | <u>\$ 145</u>                         | <u>\$ (1,156)</u>                      | <u>\$ 58,610</u>                |

Nearly 80% of our mortgage-backed securities are issuances of government-sponsored enterprises.

Included in the equity securities at December 31, 2011 and 2010, were shares of stock in each Federal Home Loan Bank (the "FHLB") of Des Moines, Chicago, Dallas, San Francisco, Seattle and Topeka at an amortized cost of \$14.4 million and \$15.8 million, respectively. There were no unrealized gains or losses recorded on these securities as they are not readily marketable. Heartland considers its FHLB stock as a long-term investment that provides access to competitive products and liquidity. During 2009, certain FHLBs in the FHLB System suspended repurchases of excess capital stock. Heartland evaluates impairment in these investments based on the ultimate recoverability of the par value and at December 31, 2011, did not consider the investments to be other than temporarily impaired.

The amortized cost and estimated fair value of debt securities available for sale at December 31, 2011, by contractual maturity using estimated prepayment speeds on mortgage-backed securities, are as follows. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without penalties.

(Dollars in thousands)

|                                       | <u>Amortized Cost</u> | <u>Estimated Fair Value</u> |
|---------------------------------------|-----------------------|-----------------------------|
| <b>Securities available for sale:</b> |                       |                             |
| Due in 1 year or less                 | \$ 174,266            | \$ 175,245                  |
| Due in 1 to 5 years                   | 534,848               | 542,457                     |
| Due in 5 to 10 years                  | 117,289               | 121,001                     |
| Due after 10 years                    | 392,668               | 405,421                     |
| <b>Total</b>                          | <u>\$ 1,219,071</u>   | <u>\$ 1,244,124</u>         |

The amortized cost and estimated fair value of debt securities held to maturity at December 31, 2011, by contractual maturity using estimated prepayment speeds on mortgage-backed securities, are as follows. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without penalties.

(Dollars in thousands)

|                                     | <u>Amortized Cost</u> | <u>Estimated Fair Value</u> |
|-------------------------------------|-----------------------|-----------------------------|
| <b>Securities held to maturity:</b> |                       |                             |
| Due in 1 year or less               | \$ 1,259              | \$ 946                      |
| Due in 1 to 5 years                 | 7,464                 | 6,254                       |
| Due in 5 to 10 years                | 1,693                 | 1,711                       |
| Due after 10 years                  | 47,844                | 48,575                      |
| <b>Total</b>                        | <u>\$ 58,260</u>      | <u>\$ 57,486</u>            |

As of December 31, 2011, securities with a fair value of \$557.0 million were pledged to secure public and trust deposits, short-term borrowings and for other purposes as required by law.

Gross gains and losses realized related to sales of securities for the years ended December 31, 2011, 2010, and 2009, are summarized as follows:

(Dollars in thousands)

|                       | 2011       | 2010       | 2009       |
|-----------------------|------------|------------|------------|
| Securities sold:      |            |            |            |
| Proceeds from sales   | \$ 493,167 | \$ 399,901 | \$ 199,745 |
| Gross security gains  | 15,302     | 8,575      | 9,012      |
| Gross security losses | 2,198      | 1,741      | 364        |

During the years ended December 31, 2011, 2010, and 2009, Heartland incurred other than temporary impairment losses of \$0, \$0 and \$40,000, respectively, on equity securities available for sale. No other than temporary impairment losses were recorded on debt securities during the years ended December 31, 2011, 2010 and 2009.

The following tables summarize 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 December 31, 2011 and 2010. 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 December 31, 2010 and 2009, respectively.

(Dollars in thousands)

|  | Less than 12 months |                   | 12 months or longer |                   | Total      |                   |
|--|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |
| <b>December 31, 2011:</b>                        |                     |                   |                     |                   |            |                   |
| U.S. government corporations and agencies        | \$ —                | \$ —              | \$ —                | \$ —              | \$ —       | \$ —              |
| Mortgage-backed securities                       | 133,538             | (1,794)           | 71,231              | (3,203)           | 204,769    | (4,997)           |
| Obligations of states and political subdivisions | 13,139              | (284)             | 4,010               | (689)             | 17,149     | (973)             |
| Corporate debt securities                        | 5,147               | (243)             | 15,346              | (817)             | 20,493     | (1,060)           |
| Total debt securities                            | 151,824             | (2,321)           | 90,587              | (4,709)           | 242,411    | (7,030)           |
| Equity securities                                | —                   | —                 | —                   | —                 | —          | —                 |
| Total temporarily impaired securities            | \$ 151,824          | \$ (2,321)        | \$ 90,587           | \$ (4,709)        | \$ 242,411 | \$ (7,030)        |
| <b>December 31, 2010:</b>                        |                     |                   |                     |                   |            |                   |
| U.S. government corporations and agencies        | \$ 107,583          | \$ (1,143)        | \$ —                | \$ —              | \$ 107,583 | \$ (1,143)        |
| Mortgage-backed securities                       | 104,724             | (2,765)           | 11,984              | (1,446)           | 116,708    | (4,211)           |
| Obligations of states and political subdivisions | 109,387             | (3,995)           | 763                 | (145)             | 110,150    | (4,140)           |
| Corporate debt securities                        | 14,974              | (1,168)           | —                   | —                 | 14,974     | (1,168)           |
| Total debt securities                            | 336,668             | (9,071)           | 12,747              | (1,591)           | 349,415    | (10,662)          |
| Equity securities                                | —                   | —                 | —                   | —                 | —          | —                 |
| Total temporarily impaired securities            | \$ 336,668          | \$ (9,071)        | \$ 12,747           | \$ (1,591)        | \$ 349,415 | \$ (10,662)       |

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 see 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 has noted credit rating reductions in a number of these securities, primarily due to the downgrade in the credit ratings of the insurance companies providing credit enhancement to that of the issuing 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 see the securities before maturity, these investments are not considered other-than-temporarily impaired.

#### **FOUR LOANS AND LEASES**

Loans and leases as of December 31, 2011 and 2010, were as follows:

(Dollars in thousands)

|  | <b>2011</b>         | <b>2010</b>         |
|--|---------------------|---------------------|
| <b>Loans and leases receivable held to maturity:</b>   |                     |                     |
| Commercial   | \$ 645,666          | \$ 558,031          |
| Commercial real estate                                 | 1,163,784           | 1,160,962           |
| Residential real estate                                | 194,436             | 163,726             |
| Agricultural and agricultural real estate              | 262,975             | 250,943             |
| Consumer   | 220,099             | 214,515             |
| Gross loans receivable held to maturity                | 2,486,960           | 2,348,177           |
| Direct financing leases held to maturity:              |                     |                     |
| Gross rents receivable                                 | 313                 | 638                 |
| Estimated residual value                               | 169                 | 415                 |
| Unearned income  | (32)                | (72)                |
| Net direct financing leases held to maturity           | 450                 | 981                 |
| Gross loans and leases receivable held to maturity     | 2,487,410           | 2,349,158           |
| Unearned discount                                      | (2,463)             | (2,581)             |
| Deferred loan fees                                     | (3,663)             | (2,590)             |
| Total net loans and leases receivable held to maturity | 2,481,284           | 2,343,987           |
| <b>Loans covered under loss share agreements:</b>      |                     |                     |
| Commercial and commercial real estate                  | 6,380               | 10,056              |
| Residential real estate                                | 4,158               | 5,792               |
| Agricultural and agricultural real estate              | 1,659               | 2,723               |
| Consumer   | 1,150               | 2,229               |
| Total loans covered under loss share agreements        | 13,347              | 20,800              |
| Allowance for loan and lease losses                    | (36,808)            | (42,693)            |
| Loans and leases receivable, net                       | <u>\$ 2,457,823</u> | <u>\$ 2,322,094</u> |

Over 60% of the loan portfolio is concentrated in the Midwestern States of Iowa, Illinois, Wisconsin and Minnesota. The remaining portion of the loan portfolio is concentrated in the Western States of New Mexico, Arizona, Montana and Colorado.

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 non-performing 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 for most of these loans and leases is based upon a discount from its market value. 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 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.

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 policies, all nonaccrual and restructured loans meeting the criteria of a troubled debt restructuring are defined as impaired loans. 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 December 31, 2011, and December 31, 2010, 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, 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 2011.

|   | 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               |
| <b>December 31, 2011</b>                  |                                     |                                 |                  |   |  |                     |
| Commercial                                | \$ 1,990                            | \$ 8,557                        | \$ 10,547        | \$ 9,293  | \$ 636,373   | \$ 645,666          |
| Commercial real estate                    | 1,929                               | 12,692                          | 14,621           | 66,467  | 1,097,317  | 1,163,784           |
| Agricultural and agricultural real estate | —                                   | 1,763                           | 1,763            | 14,385  | 248,590  | 262,975             |
| Residential real estate                   | 464                                 | 2,537                           | 3,001            | 5,905   | 188,531  | 194,436             |
| Consumer                                  | 1,097                               | 5,777                           | 6,874            | 4,391   | 215,708  | 220,099             |
| Lease financing                           | —                                   | 2                               | 2                | —   | 450  | 450                 |
| Unallocated                               | —                                   | —                               | —                | —   | —  | —                   |
| Total                                     | <u>\$ 5,480</u>                     | <u>\$ 31,328</u>                | <u>\$ 36,808</u> | <u>\$ 100,441</u>   | <u>\$ 2,386,969</u>                                      | <u>\$ 2,487,410</u> |

**December 31, 2010**

|   |                  |                  |                  |                   |                     |                     |
|---|------------------|------------------|------------------|-------------------|---------------------|---------------------|
| Commercial                                | \$ 2,837         | \$ 7,688         | \$ 10,525        | \$ 16,598         | \$ 541,433          | \$ 558,031          |
| Commercial real estate                    | 7,127            | 13,189           | 20,316           | 105,341           | 1,055,621           | 1,160,962           |
| Agricultural and agricultural real estate | 512              | 1,635            | 2,147            | 16,255            | 234,688             | 250,943             |
| Residential real estate                   | 659              | 1,722            | 2,381            | 5,450             | 158,276             | 163,726             |
| Consumer                                  | 1,026            | 5,289            | 6,315            | 3,540             | 210,975             | 214,515             |
| Lease financing                           | —                | 9                | 9                | —                 | 981                 | 981                 |
| Unallocated                               | —                | 1,000            | 1,000            | —                 | —                   | —                   |
| Total                                     | <u>\$ 12,161</u> | <u>\$ 30,532</u> | <u>\$ 42,693</u> | <u>\$ 147,184</u> | <u>\$ 2,201,974</u> | <u>\$ 2,349,158</u> |

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 December 31, 2011, and December 31, 2010, in thousands. There were no nonaccrual leases, accruing leases past due 90 days or more or restructured leases at December 31, 2011, and December 31, 2010.

|   | December 31, 2011 | December 31, 2010 |
|---|-------------------|-------------------|
| Nonaccrual loans                            | \$ 48,587         | \$ 77,875         |
| Nonaccrual troubled debt restructured loans | 8,848             | 12,637            |
| Total nonaccrual loans                      | <u>\$ 57,435</u>  | <u>\$ 90,512</u>  |
| Accruing loans past due 90 days or more     | —                 | 85                |
| Performing troubled debt restructured loans | \$ 25,704         | \$ 23,719         |

Heartland had \$34.6 million of troubled debt restructured loans at December 31, 2011, of which \$8.9 million were classified as nonaccrual and \$25.7 million were accruing according to the restructured terms. Heartland had \$36.4 million of troubled debt restructured loans at December 31, 2010, of which \$12.7 million were classified as nonaccrual and \$23.7 million were accruing according to the restructured terms.

The following table provides information on troubled debt restructured loans that were modified during the year ended December 31, 2011:

(Dollars in thousands)

|   | Year Ended December 31, 2011 |                                      |                                       |
|---|------------------------------|--------------------------------------|---------------------------------------|
|   | Number of Loans              | Pre-Modification Recorded Investment | Post-Modification Recorded Investment |
| Commercial                                  | 3                            | \$ 124                               | \$ 124                                |
| Commercial real estate                      | 13                           | 5,664                                | 5,664                                 |
| Total commercial and commercial real estate | 16                           | 5,788                                | 5,788                                 |
| Residential real estate                     | 9                            | 1,182                                | 1,182                                 |
| Agricultural and agricultural real estate   | 7                            | 2,994                                | 2,994                                 |
| Consumer                                    | —                            | —                                    | —                                     |
| Total                                       | 32                           | \$ 9,964                             | \$ 9,964                              |

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 table provides information on troubled debt restructured loans for which there was a payment default during the year ended December 31, 2011, that had been modified during the 12-month period prior to the default:

(Dollars in thousands)

|   | Year Ended December 31, 2011 |                     |
|---|------------------------------|---------------------|
|   | Number of Loans              | Recorded Investment |
| Commercial                                  | —                            | \$ —                |
| Commercial real estate                      | —                            | —                   |
| Total commercial and commercial real estate | —                            | —                   |
| Residential real estate                     | 3                            | 287                 |
| Agricultural and agricultural real estate   | —                            | —                   |
| Consumer                                    | —                            | —                   |
| Total                                       | 3                            | \$ 287              |

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 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 December 31, 2011 and December 31, 2010, 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 December 31, 2011, and December 31, 2010, in thousands:

|  | Pass                | Nonpass           | Total               |
|--|---------------------|-------------------|---------------------|
| <b>December 31, 2011</b>                                 |                     |                   |                     |
| Commercial   | \$ 596,759          | \$ 48,907         | \$ 645,666          |
| Commercial real estate                                   | 988,906             | 174,878           | 1,163,784           |
| Total commercial and commercial real estate              | 1,585,665           | 223,785           | 1,809,450           |
| Residential real estate                                  | 177,128             | 17,308            | 194,436             |
| Agricultural and agricultural real estate                | 223,247             | 39,728            | 262,975             |
| Consumer   | 211,073             | 9,026             | 220,099             |
| Lease financing  | 450                 | —                 | 450                 |
| Total gross loans and leases receivable held to maturity | <u>\$ 2,197,563</u> | <u>\$ 289,847</u> | <u>\$ 2,487,410</u> |
| <b>December 31, 2010</b>                                 |                     |                   |                     |
| Commercial   | \$ 504,207          | \$ 53,824         | \$ 558,031          |
| Commercial real estate                                   | 912,897             | 248,065           | 1,160,962           |
| Total commercial and commercial real estate              | 1,417,104           | 301,889           | 1,718,993           |
| Residential real estate                                  | 146,392             | 17,334            | 163,726             |
| Agricultural and agricultural real estate                | 220,096             | 30,847            | 250,943             |
| Consumer   | 202,533             | 11,982            | 214,515             |
| Lease financing  | 981                 | —                 | 981                 |
| Total gross loans and leases receivable held to maturity | <u>\$ 1,987,106</u> | <u>\$ 362,052</u> | <u>\$ 2,349,158</u> |

The nonpass category in the table above is comprised of approximately 43% special mention and 57% substandard as of December 31, 2011. The percent of nonpass loans on nonaccrual status as of December 31, 2011 was 20%. As of December 31, 2010, the nonpass category in the table above was comprised of approximately 37% special mention and 63% substandard. The percent of nonpass loans on nonaccrual status as of December 31, 2010 was 25%. 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 December 31, 2011, and December 31, 2010, in thousands:

|  | Accruing Loans and Leases |                        |                                |                   |                     |                  |                           |
|--|---------------------------|------------------------|--------------------------------|-------------------|---------------------|------------------|---------------------------|
|  | 30-59 Days<br>Past Due    | 60-89 Days<br>Past Due | 90 Days or<br>More Past<br>Due | Total<br>Past Due | Current             | Nonaccrual       | Total Loans<br>and Leases |
| <b>December 31, 2011</b>                                 |                           |                        |                                |                   |                     |                  |                           |
| Commercial   | \$ 220                    | \$ 479                 | \$ —                           | \$ 699            | \$ 643,273          | \$ 1,694         | \$ 645,666                |
| Commercial real estate                                   | 668                       | —                      | —                              | 668               | 1,117,274           | 45,842           | 1,163,784                 |
| Total commercial and commercial real estate              | 888                       | 479                    | —                              | 1,367             | 1,760,547           | 47,536           | 1,809,450                 |
| Residential real estate                                  | 940                       | 93                     | —                              | 1,033             | 188,865             | 4,538            | 194,436                   |
| Agricultural and agricultural real estate                | 32                        | —                      | —                              | 32                | 262,409             | 534              | 262,975                   |
| Consumer   | 2,176                     | 555                    | —                              | 2,731             | 212,541             | 4,827            | 220,099                   |
| Lease financing  | —                         | —                      | —                              | —                 | 450                 | —                | 450                       |
| Total gross loans and leases receivable held to maturity | <u>\$ 4,036</u>           | <u>\$ 1,127</u>        | <u>\$ —</u>                    | <u>\$ 5,163</u>   | <u>\$ 2,424,812</u> | <u>\$ 57,435</u> | <u>\$ 2,487,410</u>       |
| <b>December 31, 2010</b>                                 |                           |                        |                                |                   |                     |                  |                           |
| Commercial   | \$ 895                    | \$ 282                 | \$ —                           | \$ 1,177          | \$ 547,740          | \$ 9,114         | \$ 558,031                |
| Commercial real estate                                   | 5,328                     | 2,940                  | 85                             | 8,353             | 1,087,075           | 65,534           | 1,160,962                 |
| Total commercial and commercial real estate              | 6,223                     | 3,222                  | 85                             | 9,530             | 1,634,815           | 74,648           | 1,718,993                 |
| Residential real estate                                  | 2,482                     | —                      | —                              | 2,482             | 151,734             | 9,510            | 163,726                   |
| Agricultural and agricultural real estate                | 283                       | 292                    | —                              | 575               | 248,698             | 1,670            | 250,943                   |
| Consumer   | 2,369                     | 628                    | —                              | 2,997             | 206,834             | 4,684            | 214,515                   |
| Lease financing  | —                         | —                      | —                              | —                 | 981                 | —                | 981                       |
| Total gross loans and leases receivable held to maturity | <u>\$ 11,357</u>          | <u>\$ 4,142</u>        | <u>\$ 85</u>                   | <u>\$ 15,584</u>  | <u>\$ 2,243,062</u> | <u>\$ 90,512</u> | <u>\$ 2,349,158</u>       |



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 balance that was contractually due at December 31, 2011, and December 31, 2010, the outstanding loan balance recorded on the consolidated balance sheets at December 31, 2011, and December 31, 2010, any related allowance recorded for those loans as of December 31, 2011, and December 31, 2010, the average outstanding loan balance recorded on the consolidated balance sheets during the years ended December 31, 2011 and 2010, and the interest income recognized on the impaired loans during the years ended December 31, 2011 and 2010, in thousands:

| <b>December 31, 2011</b>                          | <b>Unpaid<br/>Contractual<br/>Balance</b> | <b>Loan<br/>Balance</b> | <b>Related<br/>Allowance<br/>Recorded</b> | <b>Year-to-Date<br/>Avg. Loan<br/>Balance</b> | <b>Year-to-Date<br/>Interest<br/>Income<br/>Recognized</b> |
|---|---|-------------------------|---|---|--|
| <b>Impaired loans with a related allowance</b>    |   |                         |   |   |  |
| Commercial  | \$ 8,433                                  | \$ 8,397                | \$ 1,990                                  | \$ 9,395                                      | \$ 434   |
| Commercial real estate                            | 13,558                                    | 13,558                  | 1,929                                     | 32,471  | 412  |
| Total commercial and commercial real estate       | 21,991                                    | 21,955                  | 3,919                                     | 41,866  | 846  |
| Residential real estate                           | 1,776                                     | 1,775                   | 464                                       | 1,854   | 57   |
| Agricultural and agricultural real estate         | —   | —                       | —   | 2,722   | —  |
| Consumer  | 2,764                                     | 2,764                   | 1,097                                     | 2,688   | 32   |
| Total loans held to maturity                      | <u>\$ 26,531</u>                          | <u>\$ 26,494</u>        | <u>\$ 5,480</u>                           | <u>\$ 49,130</u>                              | <u>\$ 935</u>  |
| <b>Impaired loans without a related allowance</b> |   |                         |   |   |  |
| Commercial  | \$ 1,737                                  | \$ 896                  | \$ —                                      | \$ 2,221                                      | \$ 2   |
| Commercial real estate                            | 79,876                                    | 52,909                  | —   | 54,657  | 804  |
| Total commercial and commercial real estate       | 81,613                                    | 53,805                  | —   | 56,878  | 806  |
| Residential real estate                           | 4,324                                     | 4,130                   | —   | 4,293   | 46   |
| Agricultural and agricultural real estate         | 14,428                                    | 14,385                  | —   | 14,302  | 557  |
| Consumer  | 2,226                                     | 1,627                   | —   | 1,470   | 5  |
| Total loans held to maturity                      | <u>\$ 102,591</u>                         | <u>\$ 73,947</u>        | <u>\$ —</u>                               | <u>\$ 76,943</u>                              | <u>\$ 1,414</u>  |
| <b>Total impaired loans held to maturity</b>      |   |                         |   |   |  |
| Commercial  | \$ 10,170                                 | \$ 9,293                | \$ 1,990                                  | \$ 11,616                                     | \$ 436   |
| Commercial real estate                            | 93,434                                    | 66,467                  | 1,929                                     | 87,128  | 1,216  |
| Total commercial and commercial real estate       | 103,604                                   | 75,760                  | 3,919                                     | 98,744  | 1,652  |
| Residential real estate                           | 6,100                                     | 5,905                   | 464                                       | 6,147   | 103  |
| Agricultural and agricultural real estate         | 14,428                                    | 14,385                  | —   | 17,024  | 557  |
| Consumer  | 4,990                                     | 4,391                   | 1,097                                     | 4,158   | 37   |
| Total impaired loans held to maturity             | <u>\$ 129,122</u>                         | <u>\$ 100,441</u>       | <u>\$ 5,480</u>                           | <u>\$ 126,073</u>                             | <u>\$ 2,349</u>  |

| December 31, 2010                                 | Unpaid<br>Contractual<br>Balance | Loan<br>Balance   | Related<br>Allowance<br>Recorded | Year-to-Date<br>Avg. Loan<br>Balance | Year-to-Date<br>Interest<br>Income<br>Recognized |
|---|----------------------------------|-------------------|----------------------------------|--------------------------------------|--|
| <b>Impaired loans with a related allowance</b>    |                                  |                   |                                  |                                      |  |
| Commercial  | \$ 14,936                        | \$ 14,936         | \$ 2,837                         | \$ 15,471                            | \$ 481   |
| Commercial real estate                            | 35,365                           | 35,282            | 7,127                            | 36,545                               | 1,394  |
| Total commercial and commercial real estate       | 50,301                           | 50,218            | 9,964                            | 52,016                               | 1,875  |
| Residential real estate                           | 2,577                            | 2,415             | 659                              | 1,390                                | 7  |
| Agricultural and agricultural real estate         | 3,911                            | 3,911             | 512                              | 3,707                                | 181  |
| Consumer  | 2,445                            | 2,431             | 1,026                            | 1,740                                | 70   |
| Total loans held to maturity                      | <u>\$ 59,234</u>                 | <u>\$ 58,975</u>  | <u>\$ 12,161</u>                 | <u>\$ 58,853</u>                     | <u>\$ 2,133</u>                                  |
| <b>Impaired loans without a related allowance</b> |                                  |                   |                                  |                                      |  |
| Commercial  | \$ 4,378                         | \$ 1,662          | \$ —                             | \$ 1,722                             | \$ 1   |
| Commercial real estate                            | 92,979                           | 70,059            | —                                | 72,567                               | 1,026  |
| Total commercial and commercial real estate       | 97,357                           | 71,721            | —                                | 74,289                               | 1,027  |
| Residential real estate                           | 3,515                            | 3,035             | —                                | 1,748                                | 47   |
| Agricultural and agricultural real estate         | 12,401                           | 12,344            | —                                | 11,701                               | 391  |
| Consumer  | 1,458                            | 1,109             | —                                | 793                                  | 2  |
| Total loans held to maturity                      | <u>\$ 114,731</u>                | <u>\$ 88,209</u>  | <u>\$ —</u>                      | <u>\$ 88,531</u>                     | <u>\$ 1,467</u>                                  |
| <b>Total impaired loans held to maturity</b>      |                                  |                   |                                  |                                      |  |
| Commercial  | \$ 19,314                        | \$ 16,598         | \$ 2,837                         | \$ 17,193                            | \$ 482   |
| Commercial real estate                            | 128,344                          | 105,341           | 7,127                            | 109,112                              | 2,420  |
| Total commercial and commercial real estate       | 147,658                          | 121,939           | 9,964                            | 126,305                              | 2,902  |
| Residential real estate                           | 6,092                            | 5,450             | 659                              | 3,138                                | 54   |
| Agricultural and agricultural real estate         | 16,312                           | 16,255            | 512                              | 15,408                               | 572  |
| Consumer  | 3,903                            | 3,540             | 1,026                            | 2,533                                | 72   |
| Total impaired loans held to maturity             | <u>\$ 173,965</u>                | <u>\$ 147,184</u> | <u>\$ 12,161</u>                 | <u>\$ 147,384</u>                    | <u>\$ 3,600</u>                                  |

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 will cover 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 that date 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 can not carryover 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 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 covered loans at December 31, 2011, and December 31, 2010, consisted of impaired and nonimpaired loans purchased and are summarized in the following table:

(Dollars in thousands)

|   | December 31, 2011              |                                       |                           | December 31, 2010              |                                       |                           |
|---|--------------------------------|---------------------------------------|---------------------------|--------------------------------|---------------------------------------|---------------------------|
|   | Impaired<br>Purchased<br>Loans | Non<br>Impaired<br>Purchased<br>Loans | Total<br>Covered<br>Loans | Impaired<br>Purchased<br>Loans | Non<br>Impaired<br>Purchased<br>Loans | Total<br>Covered<br>Loans |
| Commercial and commercial real estate     | \$ 2,553                       | \$ 3,827                              | \$ 6,380                  | \$ 4,256                       | \$ 5,800                              | \$ 10,056                 |
| Residential real estate                   | —                              | 4,158                                 | 4,158                     | —                              | 5,792                                 | 5,792                     |
| Agricultural and agricultural real estate | —                              | 1,659                                 | 1,659                     | 379                            | 2,344                                 | 2,723                     |
| Consumer loans                            | 503                            | 647                                   | 1,150                     | 690                            | 1,539                                 | 2,229                     |
| Total Covered Loans                       | <u>\$ 3,056</u>                | <u>\$ 10,291</u>                      | <u>\$ 13,347</u>          | <u>\$ 5,325</u>                | <u>\$ 15,475</u>                      | <u>\$ 20,800</u>          |

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 were \$9.0 million. At December 31, 2011, and December 31, 2010, 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 December 31, 2011, and December 31, 2010.

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.

Loans are made in the normal course of business to directors, officers and principal holders of equity securities of Heartland. The terms of these loans, including interest rates and collateral, are similar to those prevailing for comparable transactions and do not involve more than a normal risk of collectibility. Changes in such loans during the years ended December 31, 2011 and 2010, were as follows:

(Dollars in thousands)

|                              | 2011             | 2010             |
|------------------------------|------------------|------------------|
| Balance at beginning of year | \$ 75,565        | \$ 86,850        |
| Advances                     | 15,606           | 10,910           |
| Repayments                   | (22,422)         | (22,195)         |
| Balance, end of year         | <u>\$ 68,749</u> | <u>\$ 75,565</u> |

## FIVE ALLOWANCE FOR LOAN AND LEASE LOSSES

Changes in the allowance for loan and lease losses for the years ended December 31, 2011, 2010 and 2009, were as follows:

(Dollars in thousands)

|   | 2011             | 2010             | 2009             |
|---|------------------|------------------|------------------|
| Balance at beginning of year                          | \$ 42,693        | \$ 41,848        | \$ 35,651        |
| Provision for loan and lease losses                   | 29,365           | 32,508           | 39,377           |
| Recoveries on loans and leases previously charged-off | 4,730            | 2,387            | 1,785            |
| Loans and leases charged-off                          | (39,980)         | (34,050)         | (34,965)         |
| Balance at end of year                                | <u>\$ 36,808</u> | <u>\$ 42,693</u> | <u>\$ 41,848</u> |

Changes in the allowance for loan and lease losses for the year ended December 31, 2011, were as follows, in thousands:

|                              | Commercial       | Commercial<br>Real Estate | Agricultural    | Residential<br>Real Estate | Consumer        | Leases      | Unallocated | Total            |
|------------------------------|------------------|---------------------------|-----------------|----------------------------|-----------------|-------------|-------------|------------------|
| Balance at December 31, 2010 | \$ 10,525        | \$ 20,316                 | \$ 2,147        | \$ 2,381                   | \$ 6,315        | \$ 9        | \$ 1,000    | \$ 42,693        |
| Provision                    | 1,941            | 20,941                    | (250)           | 2,452                      | 5,288           | (7)         | (1,000)     | 29,365           |
| Recoveries                   | 1,051            | 2,868                     | 33              | 46                         | 732             | —           | —           | 4,730            |
| Charge-offs                  | (2,970)          | (29,504)                  | (167)           | (1,878)                    | (5,461)         | —           | —           | (39,980)         |
| Balance at December 31, 2011 | <u>\$ 10,547</u> | <u>\$ 14,621</u>          | <u>\$ 1,763</u> | <u>\$ 3,001</u>            | <u>\$ 6,874</u> | <u>\$ 2</u> | <u>\$ —</u> | <u>\$ 36,808</u> |

## SIX PREMISES, FURNITURE AND EQUIPMENT

Premises, furniture and equipment as of December 31, 2011 and 2010, were as follows:

(Dollars in thousands)

|  | 2011              | 2010              |
|--|-------------------|-------------------|
| Land and land improvements             | \$ 33,092         | \$ 35,262         |
| Buildings and building improvements    | 92,125            | 100,501           |
| Furniture and equipment                | 45,128            | 45,412            |
| Total                                  | 170,345           | 181,175           |
| Less accumulated depreciation          | (60,139)          | (60,163)          |
| Premises, furniture and equipment, net | <u>\$ 110,206</u> | <u>\$ 121,012</u> |

Depreciation expense on premises, furniture and equipment was \$6.3 million, \$7.1 million and \$7.3 million for 2011, 2010, and 2009, respectively.

## SEVEN

### GOODWILL AND INTANGIBLE ASSETS

The following table summarizes the changes in Heartland's goodwill for 2011 and 2010:

(Dollars in thousands)

|                                       |           |
|---------------------------------------|-----------|
| Goodwill balance at December 31, 2009 | \$ 27,548 |
| Impairment charges in 2010            | (1,639)   |
| Goodwill balance at December 31, 2010 | 25,909    |
| Impairment charge in 2011             | —         |
| Goodwill balance at December 31, 2011 | \$ 25,909 |

#### *Correction of Prior Period Error*

In the third quarter of 2010, Heartland identified a \$1.6 million error in the independent third party valuation utilized by Heartland for the calculation of goodwill impairment recorded at Rocky Mountain Bank in the fourth quarter of 2009. After consideration of both quantitative and qualitative factors, management determined the amount was not material to the financial statements and thus recorded such amount in the third quarter of 2010, when it was discovered, as a reduction of "goodwill" in the assets section of the balance sheet by \$1.6 million, with a corresponding \$1.6 million recorded as a goodwill impairment charge in the statement of income. The correction of this error does not impact the statement of cash flows contained in this Form 10-K and this correction was not considered material to the prior period financial statements.

Goodwill impairment charges were recorded at Rocky Mountain Bank and Arizona Bank & Trust in 2009 of \$7.5 million and \$5.2 million, respectively.

The gross carrying amount of intangible assets and the associated accumulated amortization at December 31, 2011 and 2010, are presented in the tables below:

|                                  | December 31, 2011     |                          | December 31, 2010     |                          |
|----------------------------------|-----------------------|--------------------------|-----------------------|--------------------------|
|                                  | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Amortizing intangible assets:    |                       |                          |                       |                          |
| Core deposit intangibles         | \$ 9,957              | \$ 8,815                 | \$ 9,957              | \$ 8,345                 |
| Mortgage servicing rights        | 16,779                | 5,503                    | 15,297                | 4,087                    |
| Customer relationship intangible | 1,177                 | 635                      | 1,177                 | 533                      |
| Total                            | \$ 27,913             | \$ 14,953                | \$ 26,431             | \$ 12,965                |
| Unamortized intangible assets    |                       | \$ 12,960                |                       | \$ 13,466                |

The following table shows the estimated future amortization expense related to intangible assets:

(Dollars in thousands)

|              | Core Deposit Intangibles | Mortgage Servicing Rights | Customer Relationship Intangible | Total    |
|--------------|--------------------------|---------------------------|----------------------------------|----------|
| Year ending: |                          |                           |                                  |          |
| 2012         | \$ 441                   | \$ 3,759                  | \$ 55                            | \$ 4,255 |
| 2013         | 423                      | 3,007                     | 45                               | 3,475    |
| 2014         | 184                      | 2,255                     | 43                               | 2,482    |
| 2015         | 15                       | 1,503                     | 42                               | 1,560    |
| 2016         | 14                       | 752                       | 41                               | 807      |
| Thereafter   | 65                       | —                         | 316                              | 381      |

Projections of amortization expense for mortgage servicing rights are based on existing asset balances and the existing interest rate environment as of December 31, 2011. Heartland's actual experience may be significantly different depending upon changes in mortgage interest rates and market conditions.

The following table summarizes the changes in capitalized mortgage servicing rights:

(Dollars in thousands)

|                            | 2011             | 2010             |
|----------------------------|------------------|------------------|
| Balance, beginning of year | \$ 11,210        | \$ 9,533         |
| Originations               | 3,723            | 5,778            |
| Amortization               | (3,638)          | (4,101)          |
| Valuation adjustment       | (19)             | —                |
| Balance, end of year       | <u>\$ 11,276</u> | <u>\$ 11,210</u> |

Mortgage loans serviced for others were \$1.54 billion and \$1.40 billion as of December 31, 2011 and 2010, respectively. Custodial escrow balances maintained in connection with the mortgage loan servicing portfolio were approximately \$7.0 million and \$6.2 million as of December 31, 2011 and 2010, respectively. The fair value of Heartland's mortgage servicing rights was estimated at \$11.5 million and \$12.3 million at December 31, 2011, and December 31, 2010, respectively. Heartland's mortgage servicing rights are separated into 15- and 30-year tranches. The 15-year tranche had a fair value of \$2.41 million in comparison with the book value of \$2.43 million. Accordingly, a valuation allowance of \$19,000 was required as of December 31, 2011 and there was no valuation allowance on mortgage servicing rights at December 31, 2010.

## **EIGHT DEPOSITS**

At December 31, 2011, the scheduled maturities of time certificates of deposit were as follows:

(Dollars in thousands)

|            |                   |
|------------|-------------------|
| 2012       | \$ 346,977        |
| 2013       | 143,428           |
| 2014       | 145,193           |
| 2015       | 55,739            |
| 2016       | 72,398            |
| Thereafter | 30,901            |
|            | <u>\$ 794,636</u> |

The aggregate amount of time certificates of deposit in denominations of \$100,000 or more as of December 31, 2011 and 2010, were \$247.5 million and \$274.9 million, respectively.

Interest expense on deposits for the years ended December 31, 2011, 2010 and 2009, was as follows:

(Dollars in thousands)

|  | 2011             | 2010             | 2009             |
|--|------------------|------------------|------------------|
| Savings and money market accounts                                  | \$ 9,090         | \$ 13,677        | \$ 18,407        |
| Time certificates of deposit in denominations of \$100,000 or more | 5,928            | 7,534            | 11,202           |
| Other time deposits  | 14,206           | 17,061           | 23,135           |
| Interest expense on deposits                                       | <u>\$ 29,224</u> | <u>\$ 38,272</u> | <u>\$ 52,744</u> |

## NINE

### SHORT-TERM BORROWINGS

Short-term borrowings as of December 31, 2011 and 2010, were as follows:

(Dollars in thousands)

|   | 2011              | 2010              |
|---|-------------------|-------------------|
| Securities sold under agreement to repurchase | \$ 253,496        | \$ 212,740        |
| Federal funds purchased                       | 10,800            | 9,575             |
| U.S. Treasury demand note                     | —                 | 3,966             |
| Notes payable to unaffiliated banks           | 5,785             | 9,583             |
| Total   | <u>\$ 270,081</u> | <u>\$ 235,864</u> |

Prior to April 2011, Heartland maintained credit lines with two unaffiliated banks, one of which provided borrowing authority for \$15.0 million and one of which provided borrowing authority of \$5.0 million. On April 20, 2011, Heartland entered into a debt arrangement with one of these banks to convert the \$15.0 million revolving line of credit into a \$15.0 million amortizing term loan with a maturity date of April 20, 2016, and to add \$5.0 million in borrowing capacity in the form of a revolving line of credit with a maturity date of April 20, 2013. At the same time, Heartland entered into an interest rate swap transaction designated as a cash flow hedge, with the bank to fix the term loan at 5.14% for the full five-year term. Accordingly after this debt arrangement, Heartland has two credit lines with two unaffiliated banks, both with revolving borrowing capacity of \$5.0 million and one with an additional \$15.0 million amortizing term loan. At December 31, 2011, Heartland had no outstanding balance on either line of credit. The agreement with the revolving credit line and term loan contains specific financial covenants, all of which Heartland was in compliance with at December 31, 2011:

- Heartland will maintain regulatory capital at well capitalized levels on a consolidated basis.
- Heartland will maintain on a consolidated basis a minimum return on average assets of at least .50% tested quarterly on a rolling four-quarter basis.
- On a consolidated basis, Heartland's nonperforming assets to Tier 1 capital and allowance for loan and lease losses will not exceed 35%, measured continuously.
- Heartland will maintain on a consolidated basis a minimum allowance for loan and lease losses to gross loans and leases ratio of 1.25%.
- Heartland will inform the lender of any material regulatory non-compliance or written agreement concerning Heartland or any of its subsidiaries.
- A senior officer of Heartland will submit a written quarterly statement of compliance with the financial covenants established under the credit agreement.

All retail repurchase agreements as of December 31, 2011 and 2010 were due within twelve months.

Average and maximum balances and rates on aggregate short-term borrowings outstanding during the years ended December 31, 2011, 2010, and 2009, were as follows:

(Dollars in thousands)

|   | 2011       | 2010       | 2009       |
|---|------------|------------|------------|
| Maximum month-end balance                   | \$ 270,081 | \$ 235,864 | \$ 205,747 |
| Average month-end balance                   | 197,527    | 198,382    | 140,289    |
| Weighted average interest rate for the year | 0.44%      | 0.58%      | 0.51%      |
| Weighted average interest rate at year-end  | 0.35%      | 0.48%      | 0.58%      |

Dubuque Bank and Trust Company is a participant in the Borrower-In-Custody of Collateral Program at the Federal Reserve Bank of Chicago, which provides the capability to borrow short-term funds under the Discount Window Program. Advances under this program were collateralized by a portion of the commercial loan portfolio of Dubuque Bank and Trust Company in the amount of \$82.8 million at December 31, 2011, and \$100.7 million at December 31, 2010. There were no borrowings under the Discount Window Program outstanding at year-end 2011 and 2010.

## TEN OTHER BORROWINGS

Other borrowings at December 31, 2011 and 2010, were as follows:

(Dollars in thousands)

|   | 2011              | 2010              |
|---|-------------------|-------------------|
| Advances from the FHLB; weighted average call dates at December 31, 2011 and 2010 were September 2014 and July 2014, respectively; and weighted average interest rates were 3.33% and 3.29%, respectively           | \$ 132,297        | \$ 135,709        |
| Wholesale repurchase agreements; weighted average call dates at December 31, 2011 and 2010 were August 2012 and February 2012, respectively; and weighted average interest rates were 3.22% and 3.12%, respectively | 85,000            | 85,000            |
| Trust preferred securities  | 113,405           | 113,405           |
| Senior notes  | 27,500            | 24,500            |
| Note payable to unaffiliated bank   | 14,221            | —                 |
| Obligations to repurchase minority interest shares of Summit Bank & Trust   | —                 | 2,994             |
| Contracts payable for purchase of real estate and other assets  | 397               | 919               |
| Total   | <u>\$ 372,820</u> | <u>\$ 362,527</u> |

The Heartland banks are members of the FHLB of Des Moines, Chicago, Dallas, San Francisco, Seattle and Topeka. The advances from the FHLB are collateralized by the Heartland banks' investments in FHLB stock of \$8.8 million and \$8.7 million at December 31, 2011 and 2010, respectively. Additional collateral provided by the Heartland banks to the FHLB was one-to-four family residential mortgages, commercial and agricultural mortgages and securities pledged totaling \$1.01 billion at December 31, 2011, and \$989.4 million at December 31, 2010.

Heartland has entered into various wholesale repurchase agreements which had balances totaling \$85.0 million at December 31, 2011, and 2010. A schedule of Heartland's wholesale repurchase agreements outstanding as of December 31, 2011, were as follows:

(Dollars in thousands)

| Counterparty:            | Amount           | Interest Rate as of 12/31/11 <sup>(1)</sup> | Issue Date | Maturity Date | Callable Date |
|--------------------------|------------------|---|------------|---------------|---------------|
| JP Morgan Chase          | \$ 25,000        | 2.48%                                       | 1/17/2008  | 1/17/2013     | 1/17/2012     |
| Citigroup Global Markets | 15,000           | 3.32%                                       | 4/17/2008  | 4/17/2015     | 4/17/2012     |
| Citigroup Global Markets | 20,000           | 3.61% <sup>(2)</sup>                        | 4/17/2008  | 4/17/2018     | 1/17/2012     |
| Barclays Capital         | 10,000           | 4.07%                                       | 7/01/2008  | 7/01/2013     | 7/01/2013     |
| Citigroup Global Markets | 15,000           | 2.69%                                       | 1/23/2009  | 1/23/2014     | -             |
|                          | <u>\$ 85,000</u> |   |            |               |               |

(1) Interest rates are fixed with the exception of the interest rate on the \$20.0 million transaction with Citigroup Global Markets.

(2) Interest rate resets quarterly on the 17th of January, April, July and October of each year until maturity. Embedded within the contract is a cap interest rate of 3.61%.



Heartland currently has six wholly-owned trust subsidiaries that were formed to issue trust preferred securities. The proceeds from the offerings were used to purchase junior subordinated debentures from Heartland. The proceeds are being used for general corporate purposes. Heartland has the option to shorten the maturity date to a date not earlier than the callable date. Heartland may not shorten the maturity date without prior approval of the Board of Governors of the Federal Reserve System, if required. Prior redemption is permitted under certain circumstances, such as changes in tax or regulatory capital rules. In connection with these offerings, the balance of deferred issuance costs included in other assets was \$240,000 as of December 31, 2011. These deferred costs are amortized on a straight-line basis over the life of the debentures. The majority of the interest payments are due quarterly. A schedule of Heartland's trust preferred offerings outstanding as of December 31, 2011, were as follows:

(Dollars in thousands)

|   | <b>Amount<br/>Issued</b> | <b>Interest<br/>Rate</b> | <b>Interest Rate as<br/>of 12/31/11 <sup>(1)</sup></b> | <b>Maturity<br/>Date</b> | <b>Callable<br/>Date</b> |
|---|--------------------------|--------------------------|--|--------------------------|--------------------------|
| Rocky Mountain Statutory Trust I        | \$ 5,155                 | 10.60%                   | 10.60%   | 09/07/2030               | 03/07/2012               |
| Heartland Financial Statutory Trust III | 20,619                   | 8.25%                    | 8.25%  | 10/10/2033               | 03/31/2012               |
| Heartland Financial Statutory Trust IV  | 25,774                   | 2.75% over Libor         | 3.30% <sup>(2)</sup>                                   | 03/17/2034               | 03/17/2012               |
| Heartland Financial Statutory Trust V   | 20,619                   | 1.33% over Libor         | 1.73% <sup>(3)</sup>                                   | 04/07/2036               | 04/07/2012               |
| Heartland Financial Statutory Trust VI  | 20,619                   | 6.75%                    | 6.75%  | 09/15/2037               | 06/15/2012               |
| Heartland Financial Statutory Trust VII | 20,619                   | 1.48% over Libor         | 2.01% <sup>(4)</sup>                                   | 09/01/2037               | 09/01/2012               |
|   | <u>\$ 113,405</u>        |                          |  |                          |                          |

(1) Effective weighted average interest rate as of December 31, 2011, was 6.13% due to interest rate swap transactions on the variable rate securities as discussed in Note 11 to Heartland's consolidated financial statements.

(2) Effective interest rate as of December 31, 2011, was 5.33% due to an interest rate swap transaction as discussed in Note 11 to Heartland's consolidated financial statements.

(3) Effective interest rate as of December 31, 2011, was 4.69% due to an interest rate swap transaction as discussed in Note 11 to Heartland's consolidated financial statements.

(4) Effective interest rate as of December 31, 2011, was 4.70% due to an interest rate swap transaction as discussed in Note 11 to Heartland's consolidated financial statements.

For regulatory purposes, \$112.7 million and \$106.9 million of the capital securities qualified as Tier 1 capital for regulatory purposes as of December 31, 2011 and 2010, respectively.

On December 3, 2010, Heartland completed a private debt offering of its senior notes. The notes were sold in a private placement to various accredited investors. A total of \$24.5 million was issued in five private transactions beginning on October 25, 2010, and ending on December 3, 2010. On March 11, 2011, Heartland issued an additional \$3.0 million of its senior notes to one additional accredited investor. The senior notes are unsecured, bear interest at 5% per annum payable quarterly, and mature on December 1, 2015. There are no covenants associated with the senior notes.

Heartland repurchased the common shares of Summit Bank & Trust owned by minority shareholders on October 31, 2011 for \$2.6 million in cash. Heartland had an agreement with the minority shareholders of Summit Bank & Trust that required Heartland to repurchase the common shares five years from the date of opening at a minimum return of 7.66% on the original investment amount.

Future payments at December 31, 2011, for other borrowings follow in the table below. Callable FHLB advances and wholesale repurchase agreements are included in the table at their call date.

(Dollars in thousands)

|            |                   |
|------------|-------------------|
| 2012       | \$ 66,651         |
| 2013       | 28,431            |
| 2014       | 16,483            |
| 2015       | 136,545           |
| 2016       | 9,369             |
| Thereafter | 115,341           |
|            | <u>\$ 372,820</u> |

## **ELEVEN**

### **DERIVATIVE FINANCIAL INSTRUMENTS**

Heartland uses derivative financial instruments as part of its interest rate risk management strategy, including interest rate swaps, caps, floors and collars and certain interest rate lock commitments and forward sales of securities related to mortgage banking activities. Heartland's objectives are to add stability to its net interest margin and to manage its exposure to movements in interest rates. The contract or notional amount of a derivative is used to determine, along with the other terms of the derivative, the amounts to be exchanged between the counterparties. Heartland is exposed to credit risk in the event of nonperformance by counterparties to financial instruments. 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. Heartland monitors counterparty risk in accordance with the provisions of ASC 815. In addition, interest rate-related instruments generally contain language outlining collateral pledging requirements for each counterparty. Collateral must be posted when the market value exceeds certain threshold limits which are determined by credit ratings of each counterparty. Heartland was required to pledge \$6.3 million and \$4.6 million of cash as collateral at December 31, 2011 and 2010, respectively.

Heartland's derivative and hedging instruments are recorded at fair value on the consolidated balances sheets. See Note 19, "Fair Value Measurements," for additional fair value information and disclosures.

#### Cash Flow Hedges

Heartland has variable rate funding which creates exposure to variability in interest payments due to changes in interest rates. To manage the interest rate risk related to the variability of interest payments, Heartland has entered into various interest rate swap agreements. Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are received or made on Heartland's variable-rate liabilities. For the year ended December 31, 2011, the change in net unrealized losses on cash flow hedges reflects changes in the fair value of the swaps and reclassification from accumulated other comprehensive income to interest expense totaling \$2.0 million. For the next twelve months, Heartland estimates that cash payments and reclassification from accumulated other comprehensive income to interest expense will total \$2.1 million.

Heartland executed an interest rate swap transaction on April 5, 2011, with an effective date of April 20, 2011, and an expiration date of April 20, 2016, to effectively convert \$15.0 million of its newly issued variable rate amortizing debt to fixed rate debt. For accounting purposes, this swap transaction is designated as a cash flow hedge of the changes in cash flows attributable to changes in one-month LIBOR, the benchmark interest rate being hedged, associated with the interest payments made on an amount of Heartland's debt principal equal to the then-outstanding swap notional amount. At inception, Heartland asserted that the underlying principal balance would remain outstanding throughout the hedge transaction making it probable that sufficient LIBOR-based interest payments would exist through the maturity date of the swap.

During the first quarter of 2009, Heartland entered into three forward-starting interest rate swap transactions to effectively convert \$65.0 million of its variable interest rate subordinated debentures (issued in connection with the trust preferred securities of Heartland Financial Statutory Trust IV, V and VII) to fixed interest rate debt. For accounting purposes, these three swap transactions are designated as cash flow hedges of the changes in cash flows attributable to changes in LIBOR, the benchmark interest rate being hedged, 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 would remain outstanding throughout the hedge transaction making it probable that sufficient LIBOR-based interest payments would exist through the maturity date of the swaps.

The table below identifies the balance sheet category and fair values of Heartland's derivative instruments designated as cash flow hedges:

(Dollars in thousands)

|                          | <b>Notional<br/>Amount</b> | <b>Fair Value</b> | <b>Balance Sheet<br/>Category</b> | <b>Receive<br/>Rate</b> | <b>Weighted<br/>Average<br/>Pay Rate</b> | <b>Maturity</b> |
|--------------------------|----------------------------|-------------------|-----------------------------------|-------------------------|--|-----------------|
| <b>December 31, 2011</b> |                            |                   |                                   |                         |  |                 |
| Interest rate swap       | \$ 14,221                  | \$ (725)          | Other Liabilities                 | 3.035%                  | 5.140%                                   | 4/20/2016       |
| Interest rate swap       | 25,000                     | (1,032)           | Other Liabilities                 | 0.559%                  | 2.580%                                   | 3/17/2014       |
| Interest rate swap       | 20,000                     | (2,064)           | Other Liabilities                 | 0.527%                  | 3.220%                                   | 3/01/2017       |
| Interest rate swap       | 20,000                     | (2,584)           | Other Liabilities                 | 0.384%                  | 3.355%                                   | 1/07/2020       |
| <b>December 31, 2010</b> |                            |                   |                                   |                         |  |                 |
| Interest rate swap       | \$ 25,000                  | \$ (996)          | Other Liabilities                 | 0.302%                  | 2.580%                                   | 3/17/2014       |
| Interest rate swap       | 20,000                     | (873)             | Other Liabilities                 | 0.296%                  | 3.220%                                   | 3/01/2017       |
| Interest rate swap       | 20,000                     | (479)             | Other Liabilities                 | 0.290%                  | 3.355%                                   | 1/07/2020       |

The table below identifies the gains and losses recognized on Heartland's derivative instruments designated as cash flow hedges:

(Dollars in thousands)

|                          | <b>Effective Portion</b>        |   |                                 | <b>Ineffective Portion</b>                     |                                 |
|--------------------------|---------------------------------|---|---------------------------------|--|---------------------------------|
|                          | <b>Recognized<br/>in OCI</b>    | <b>Reclassified from AOCI into<br/>Income</b> |                                 | <b>Recognized in Income on<br/>Derivatives</b> |                                 |
|                          | <b>Amount of<br/>Gain(Loss)</b> | <b>Category</b>                               | <b>Amount of<br/>Gain(Loss)</b> | <b>Category</b>                                | <b>Amount of<br/>Gain(Loss)</b> |
| <b>December 31, 2011</b> |                                 |   |                                 |  |                                 |
| Interest rate swap       | \$ (488)                        | Interest Expense                              | \$ (216)                        | Other Income                                   | \$ (227)                        |
| Interest rate swap       | (39)                            | Interest Expense                              | (573)                           | Other Income                                   | —                               |
| Interest rate swap       | (1,195)                         | Interest Expense                              | (589)                           | Other Income                                   | —                               |
| Interest rate swap       | (2,109)                         | Interest Expense                              | (618)                           | Other Income                                   | —                               |
| <b>December 31, 2010</b> |                                 |   |                                 |  |                                 |
| Interest rate swap       | \$ (1,108)                      | Interest Expense                              | \$ (447)                        | Other Income                                   | \$ —                            |
| Interest rate swap       | (1,225)                         | Interest Expense                              | (487)                           | Other Income                                   | —                               |
| Interest rate swap       | (1,218)                         | Interest Expense                              | (615)                           | Other Income                                   | —                               |

#### Economic Hedges

Heartland has certain derivative contracts which are accounted for as economic hedges. These contracts do not qualify for hedge accounting. These contracts are carried on the balance sheet at fair value with changes in fair value recorded as a component of other noninterest income on the consolidated statements of income.

To reduce the potentially negative impact a change in interest rates would have on interest income, Heartland entered into a five year interest rate collar transaction on a notional amount of \$50 million on September 19, 2005. For accounting purposes, the collar transaction was designated as a cash flow hedge and was deemed effective on September 21, 2005 and matured on September 21, 2010. Heartland was the payer on prime at a cap strike rate of 9.0% and the counterparty was the payer on prime at a floor strike rate of 6.0%. The collar was split into four separately identified hedging relationships. These hedging relationships were associated with interest payments on certain prime rate loans (loan pools) specifically identified at each of four subsidiary banks. At various times between June 30, 2007 and June 30, 2009 the collar transactions did not meet the retrospective hedge effectiveness test for each of the four separately identified hedging relationships caused by paydowns to the loans which reduced the designated loan pools below the notional amount. Accordingly, hedge accounting ceased as of the last day the hedging relationships were deemed highly effective. During 2010, the mark to market adjustment on the total collar transaction was a loss of \$1,029,000. Cash payments received on the collar transaction during 2010 totaled \$1,047,000.

To reduce the potentially negative impact an upward movement in interest rates would have on its net interest income, Heartland entered into two cap transactions. For accounting purposes, these two cap transactions were 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 hedged interest payments made on \$40 million of Heartland's subordinated debentures that reset quarterly on a specified reset date.

The first transaction executed on January 15, 2008 was a fifty-five month interest rate cap on a notional amount of \$20 million. The cap had 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. Heartland executed an interest rate swap transaction on February 4, 2009 and converted this cap transaction into an economic hedge and hedge accounting for the cap transaction was ceased.

The second transaction executed on March 27, 2008 was a twenty-eight month interest rate cap transaction on a notional amount of \$20.0 million. The cap had an effective date of January 7, 2009, and a maturity date of April 7, 2011. When 3-month LIBOR exceeded 5.5% on a reset date, the counterparty paid 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.

#### Mortgage Derivatives

Heartland also has entered into interest rate lock commitments to originate residential mortgage loans held for sale and forward commitments to sell residential mortgage loans and mortgage backed securities that are considered derivative instruments. The fair value of these commitments is recorded on the consolidated balance sheets with the changes in fair value recorded in the consolidated statements of income as a component of gains on sale of loans held for sale. These derivative contracts are designated as free standing derivative contracts and are not designated against specific assets and liabilities on the balance sheet or forecasted transactions and therefore do not qualify for hedge accounting treatment.

The table below identifies the balance sheet category and fair values of Heartland's derivative instruments not designated as hedging instruments:

(Dollars in thousands)

|   | <u>Notional<br/>Amount</u> | <u>Fair Value</u> | <u>Balance Sheet<br/>Category</u> |
|---|----------------------------|-------------------|-----------------------------------|
| <b>December 31, 2011</b>                  |                            |                   |                                   |
| Interest rate lock commitments (mortgage) | \$ 113,438                 | \$ 3,697          | Other Assets                      |
| Interest rate cap                         | 20,000                     | —                 | Other Assets                      |
| Forward commitments                       | 91,750                     | (869)             | Other Assets                      |
| <b>December 31, 2010</b>                  |                            |                   |                                   |
| Interest rate cap                         | \$ 20,000                  | \$ 5              | Other Liabilities                 |
| Interest rate cap                         | 20,000                     | —                 | Other Liabilities                 |

The table below identifies the income statement category of the gains and losses recognized in income on Heartland's derivative instruments not designated as hedging instruments:

(Dollars in thousands)

|   | <b>Income Statement Category</b>     | <b>Amount of Gain(Loss) Recognized</b> |
|---|--------------------------------------|--|
| <b>December 31, 2011</b>                  |                                      |  |
| Interest rate lock commitments (mortgage) | Gains on Sale of Loans Held for Sale | \$ 3,697                               |
| Interest rate cap                         | Other Income                         | (5)                                    |
| Forward commitments                       | Gains on Sale of Loans Held for Sale | (869)                                  |
| <b>December 31, 2010</b>                  |                                      |  |
| Interest rate cap                         | Other Income                         | \$ (70)                                |
| Interest rate cap                         | Other Income                         | (3)                                    |
| Interest rate cap                         | Other Income                         | (1,021)                                |

## TWELVE INCOME TAXES

Income taxes for the years ended December 31, 2011, 2010, and 2009, were as follows:

(Dollars in thousands)

|                          | <b>2011</b>      | <b>2010</b>     | <b>2009</b>     |
|--------------------------|------------------|-----------------|-----------------|
| <b>Current:</b>          |                  |                 |                 |
| Federal                  | \$ 4,639         | \$ 10,338       | \$ 8,086        |
| State                    | 1,300            | 2,244           | 1,709           |
| Total current            | \$ 5,939         | \$ 12,582       | \$ 9,795        |
| <b>Deferred:</b>         |                  |                 |                 |
| Federal                  | \$ 2,905         | \$ (2,121)      | \$ (3,021)      |
| State                    | 1,458            | (615)           | 422             |
| Total deferred           | \$ 4,363         | \$ (2,736)      | \$ (2,599)      |
| Total income tax expense | <u>\$ 10,302</u> | <u>\$ 9,846</u> | <u>\$ 7,196</u> |

The income tax provisions above do not include the effects of income tax deductions resulting from exercises of stock options and the vesting of stock awards in the amounts of \$108,000, \$28,000, and \$18,000 in 2011, 2010 and 2009, respectively, which were recorded as increases to stockholders' equity.

Temporary differences between the amounts reported in the financial statements and the tax basis of assets and liabilities result in deferred taxes. Deferred tax assets and liabilities at December 31, 2011 and 2010, were as follows:

(Dollars in thousands)

|  | <b>2011</b>      | <b>2010</b>      |
|--|------------------|------------------|
| <b>Deferred tax assets:</b>  |                  |                  |
| Tax effect of net unrealized loss on derivatives reflected in stockholders' equity                   | \$ 2,211         | \$ 797           |
| Securities   | 1,225            | 1,227            |
| Allowance for loan and lease losses  | 13,754           | 16,042           |
| Deferred compensation  | 2,330            | 2,032            |
| Organization and acquisitions costs  | 467              | 541              |
| Net operating loss carryforwards   | 2,026            | 1,673            |
| Non-accrual loan interest  | 1,326            | 1,418            |
| OREO writedowns  | 4,444            | 5,356            |
| Other  | 64               | 237              |
| Gross deferred tax assets  | 27,847           | 29,323           |
| Valuation allowance  | (1,964)          | (1,242)          |
| <b>Total deferred tax assets</b>   | <b>\$ 25,883</b> | <b>\$ 28,081</b> |
| <b>Deferred tax liabilities:</b>   |                  |                  |
| Tax effect of net unrealized gain on securities available for sale reflected in stockholders' equity | (9,603)          | (5,963)          |
| Premises, furniture and equipment  | (6,402)          | (5,549)          |
| Lease financing  | (93)             | (281)            |
| Tax bad debt reserves  | (326)            | (424)            |
| Purchase accounting  | (3,434)          | (3,450)          |
| Prepaid expenses   | (664)            | (558)            |
| Mortgage servicing rights  | (4,599)          | (4,546)          |
| Deferred loan fees   | (194)            | (241)            |
| Other  | (325)            | (233)            |
| Gross deferred tax liabilities   | \$ (25,640)      | \$ (21,245)      |
| <b>Net deferred tax asset</b>  | <b>\$ 243</b>    | <b>\$ 6,836</b>  |

The deferred tax assets (liabilities) related to net unrealized gains (losses) on securities available for sale and the deferred tax assets and liabilities related to net unrealized gains (losses) on derivatives had no effect on income tax expense as these gains and losses, net of taxes, were recorded in other comprehensive income. Net operating loss carryforwards for state income tax purposes were approximately \$40.0 million at December 31, 2011, and \$35.0 million at December 31, 2010. The associated deferred tax asset, net of federal tax, was \$2.0 million at December 31, 2011, and \$1.7 million at December 31, 2010. These carryforwards expire beginning December 31, 2013, through December 31, 2031. A valuation allowance against the deferred tax asset due to the uncertainty surrounding the utilization of these state net operating loss carryforwards was \$2.0 million at December 31, 2011, and \$1.2 million at December 31, 2010. Realization of the deferred tax asset over time is dependent upon the existence of taxable income in carryback periods or the ability to generate sufficient taxable income in future periods. In determining that realization of the deferred tax asset was more likely than not, Heartland gave consideration to a number of factors including its taxable income during carryback periods, its recent earnings history, its expectations for earnings in the future and, where applicable, the expiration dates associated with its tax carryforwards.

The actual income tax expense from continuing operations differs from the expected amounts (computed by applying the U.S. federal corporate tax rate of 35% to income before income taxes) as follows:

(Dollars in thousands)

|   | 2011             | 2010            | 2009            |
|---|------------------|-----------------|-----------------|
| Computed “expected” tax on net income                       | \$ 13,421        | \$ 11,812       | \$ 4,816        |
| Increase (decrease) resulting from:                         |                  |                 |                 |
| Nontaxable interest income                                  | (3,725)          | (3,055)         | (2,700)         |
| State income taxes, net of federal tax benefit              | 2,056            | 1,059           | 1,385           |
| Nondeductible goodwill and other intangibles                | —                | 574             | 4,487           |
| Tax credits   | (798)            | (554)           | (212)           |
| Other   | (652)            | 10              | (580)           |
| Income taxes  | <u>\$ 10,302</u> | <u>\$ 9,846</u> | <u>\$ 7,196</u> |
| Effective tax rates   | 26.9%            | 29.2%           | 52.3%           |
| Effective tax rates exclusive of goodwill impairment charge | 26.9%            | 27.8%           | 27.2%           |

Heartland had investments in certain low-income housing projects totaling \$7.6 million at December 31, 2011, \$8.4 million as of December 31, 2010, and \$5.4 million as of December 31, 2009. These investments generated federal low-income housing tax credits of \$798,000 in 2011, \$554,000 in 2010 and \$212,000 in 2009. These investments are expected to generate federal low-income housing tax credits of approximately \$798,000 for 2013 and 2014, \$755,000 for 2015, \$581,000 for 2016 through 2019 and \$241,000 for 2020.

On December 31, 2011, the amount of unrecognized tax benefits was \$751,000, including \$113,000 of accrued interest and penalties. On December 31, 2010, the amount of unrecognized tax benefits was \$1.2 million, including \$217,000 of accrued interest and penalties. If recognized, the entire amount of the unrecognized tax benefits would affect the effective tax rate. A reconciliation of the beginning and ending balances for liabilities associated with unrecognized tax benefits for the years ended December 31, 2011 and 2010, follows:

(Dollars in thousands)

|  | 2011          | 2010            |
|--|---------------|-----------------|
| Balance at January 1   | \$ 1,198      | \$ 1,127        |
| Additions for tax positions related to the current year                | 104           | 315             |
| Additions for tax positions related to prior years                     | 31            | 63              |
| Reductions for tax positions due to settlement with taxing authorities | —             | —               |
| Reductions for tax positions related to prior years                    | (582)         | (307)           |
| Balance at December 31   | <u>\$ 751</u> | <u>\$ 1,198</u> |

The tax years ended December 31, 2008, and later remain subject to examination by the Internal Revenue Service. For state purposes, the tax years ended December 31, 2007, and later remain open for examination. A income tax review is currently underway with the Illinois Department of Revenue for the years 2007 and 2008. Wisconsin Community Bank, one of Heartland’s bank subsidiaries, has undergone a franchise tax review for the years ended December 31, 2002 and 2003. In dispute was \$1.1 million of deducted expenditures. During the process of appealing the field audit report, a settlement agreement was reached, which included a payment of \$260,000 in taxes and \$90,000 in interest and penalties. In addition to the years initially under review, the settlement included the years ended December 31, 2004, 2005, 2006 and 2007. The settlement payment was made during the first quarter of 2009. Heartland does not anticipate any significant increase or decrease in unrecognized tax benefits during the next twelve months.

## THIRTEEN EMPLOYEE BENEFIT PLANS

Heartland sponsors a defined contribution retirement plan covering substantially all employees. Contributions to this plan are subject to approval by the Heartland Board of Directors. The Heartland subsidiaries fund and record as an expense all approved contributions. Costs of these contributions, charged to operating expenses, were \$2.2 million, \$1.8 million, and \$1.5 million for 2011, 2010, and 2009, respectively. This plan includes an employee savings program, under which the Heartland subsidiaries make matching contributions of up to 3% of the participants' wages in 2011 and 2010 and up to 2% of the participants' wages in 2009. Costs charged to operating expenses with respect to the matching contributions were \$1.3 million, \$1.1 million and \$863,000, for 2011, 2010, and 2009, respectively.

## FOURTEEN COMMITMENTS AND CONTINGENT LIABILITIES

Heartland leases certain land and facilities under operating leases. Minimum future rental commitments at December 31, 2011, for all non-cancelable leases were as follows:

(Dollars in thousands)

|            |                  |
|------------|------------------|
| 2012       | \$ 1,440         |
| 2013       | 1,521            |
| 2014       | 1,321            |
| 2015       | 982              |
| 2016       | 899              |
| Thereafter | 5,771            |
|            | <u>\$ 11,934</u> |

Rental expense for premises and equipment leased under operating leases was \$2.0 million, \$1.4 million, \$1.8 million, for 2011, 2010, and 2009, respectively. Some of the Heartland banks lease or sublease portions of the office space they own to third parties. In addition, DB&T Community Development Corp. leases properties it owns to third parties. Occupancy expense is presented net of rental income of \$1.3 million, \$1.3 million and \$1.4 million for 2011, 2010, and 2009, respectively.

In the normal course of business, the Heartland banks make various commitments and incur certain contingent liabilities that are not presented in the accompanying consolidated financial statements. The commitments and contingent liabilities include various guarantees, commitments to extend credit and standby letters of credit.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Heartland banks evaluate each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Heartland banks upon extension of credit, is based upon management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment and income-producing commercial properties. Standby letters of credit and financial guarantees written are conditional commitments issued by the Heartland banks to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. At December 31, 2011 and 2010, commitments to extend credit aggregated \$765.8 million and \$623.2 million, respectively, and standby letters of credit aggregated \$49.1 million and \$48.7 million, respectively. Heartland enters into commitments to sell mortgage loans to reduce interest rate risk on certain mortgage loans held for sale and loan commitments which were recorded in the consolidated balance sheets at their fair values. At December 31, 2011 and 2010, Heartland had commitments to sell residential real estate loans totaling \$83.5 million and \$52.6 million, respectively. Heartland does not anticipate any material loss as a result of the commitments and contingent liabilities.

Residential mortgage loans sold to others are predominantly conventional residential first lien mortgages originated under Heartland's usual underwriting procedures, and are most often sold on a nonrecourse basis. Heartland's agreements to sell residential mortgage loans in the normal course of business usually require certain representations and warranties on the



underlying loans sold, related to credit information, loan documentation, collateral, and insurability, which if subsequently are untrue or breached, could require Heartland to repurchase certain loans affected. There have been insignificant instances of repurchase under representations and warranties. Heartland had a recorded repurchase obligation of \$613,000 at December 31, 2011, and had no repurchase obligation recorded at December 31, 2010.

Heartland has a loss reserve for unfunded commitments, including loan commitments and letters of credit. At December 31, 2011 and 2010, the reserve for unfunded commitments, which is included in other liabilities on the consolidated balance sheets, was approximately \$127,000 and \$182,000, respectively. The adequacy of the reserve for unfunded commitments is reviewed on a quarterly basis, based upon changes in the amounts of commitments, delinquencies and economic conditions.

There are certain legal proceedings pending against Heartland and its subsidiaries at December 31, 2011, that are ordinary routine litigation incidental to business. While the ultimate outcome of current legal proceedings cannot be predicted with certainty, it is the opinion of management that the resolution of these legal actions should not have a material effect on Heartland's consolidated financial position or results of operations.

## **FIFTEEN**

### **STOCK PLANS**

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 recognized in the income statement over the vesting period of the award.

On May 18, 2005, the Heartland 2005 Long-Term Incentive Plan was adopted, replacing the 2003 Stock Option Plan. Under the 2005 Long-Term Incentive Plan, 1,000,000 shares have been reserved for issuance. The 2005 Long-Term Incentive Plan is administered by the Nominating and Compensation Committee (the "Compensation Committee") of the Board of Directors. All employees and directors of, and service providers to, Heartland or its subsidiaries are eligible to become participants in the 2005 Long-Term Incentive Plan, except that non-employees may not be granted incentive stock options. The 2005 Long-Term Incentive Plan provides for the grant of non-qualified and incentive stock options, stock appreciation rights ("SARS"), stock awards and cash incentive awards. The Compensation Committee determines the specific employees who will be granted awards under the 2005 Long-Term Incentive Plan and the type and amount of any such awards. Options may be granted that are either intended to be "incentive stock options" as defined under Section 422 of the Internal Revenue Code or not intended to be incentive stock options ("non-qualified stock options"). 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. At December 31, 2011, there were 321,894 shares available for issuance under new awards that may be granted in the future under the 2005 Long-Term Incentive Plan. At December 31, 2010, there were 377,960 shares available for issuance under new awards that may be granted in the future under the 2005 Stock Option Plan. Shares available for options forfeited under the 2003 Option Plan are transferable to shares available under the 2005 Long-Term Incentive Plan.

Under the 2005 Long-Term Incentive Plan, stock awards may be granted as determined by the Heartland Compensation Committee. On January 18, 2011, restricted stock units ("RSUs") totaling 101,150 were granted to key policy-making employees. On January 19, 2010, RSUs totaling 98,200 were granted to key policy-making employees. These RSUs were granted at no cost to the employee. These RSUs represent the right 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; will not be entitled to dividends until vested; will terminate upon termination of employment, but will continue to vest after retirement if retirement occurs after the employee attains age 62 and has provided ten years of service to Heartland and will continue to vest after retirement if retirement occurs after the second anniversary of the grant date.

On October 11, 2011, performance-based RSUs totaling 21,200 were granted to key policy-making employees. These RSUs were granted at no cost to the employee. These RSUs represent the right to receive shares of Heartland common stock at a specified date in the future based on specific vesting conditions; vest over three years in three equal installments on the first, second and third anniversaries of the grant date; will be settled in common stock upon vesting; will not be entitled to dividends until vested; will terminate upon termination of employment, but will continue to vest after retirement if retirement occurs after the employee attains age 62 and has provided five years of service to Heartland.

In 2005, stock awards totaling 136,500 were granted to key policy-making employees. These stock awards were granted at no cost to the employees. These awards were contingent upon the achievement of performance objectives through December 31, 2011, and additional compensation expense was recorded through 2011.

Options have been granted with an exercise price equal to the fair market value of Heartland common stock on the date of grant and expire 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. A summary of the stock option activity under equity incentive plans for the years ending December 31, 2011, 2010, and 2009 follows:

|                                    | <b>2011<br/>Shares</b> | <b>2011<br/>Weighted-<br/>Average<br/>Exercise<br/>Price</b> | <b>2010<br/>Shares</b> | <b>2010<br/>Weighted-<br/>Average<br/>Exercise<br/>Price</b> | <b>2009<br/>Shares</b> | <b>2009<br/>Weighted-<br/>Average<br/>Exercise<br/>Price</b> |
|------------------------------------|------------------------|--|------------------------|--|------------------------|--|
| Outstanding at beginning of year   | 672,721                | \$ 20.27   | 704,471                | \$ 20.02   | 743,363                | \$ 19.79   |
| Granted                            | —                      | —  | —                      | —  | —                      | —  |
| Exercised                          | (53,625)               | 9.65   | (20,500)               | 10.68  | (22,875)               | 11.84  |
| Forfeited                          | (48,334)               | 22.73  | (11,250)               | 21.63  | (16,017)               | 21.38  |
| Outstanding at end of year         | <u>570,762</u>         | <u>\$ 21.06</u>  | <u>672,721</u>         | <u>\$ 20.27</u>  | <u>704,471</u>         | <u>\$ 20.02</u>  |
| Options exercisable at end of year | 436,245                | \$ 20.86   | 399,071                | \$ 18.80   | 311,771                | \$ 16.26   |

At December 31, 2011, vested stock options totaled 436,245 shares with a weighted average exercise price of \$20.86 per share and a weighted average remaining contractual life of 3.55 years. The intrinsic value for the vested stock options as of December 31, 2011, was \$223,000. The intrinsic value for the total of all stock options exercised during the year ended December 31, 2011, was \$305,000. The total fair value of shares under stock options and awards vested during the year ended December 31, 2011, was \$1.3 million. As of December 31, 2011 and 2010, options outstanding under equity incentive plans had exercise prices ranging from \$8.80 to \$29.65 per share and a weighted-average remaining contractual life of 4.07 and 4.80 years, respectively.

No options were granted in 2011, 2010 and 2009. Cash received from options exercised for the year ended December 31, 2011 was \$517,000, with a related tax benefit of \$108,000. Cash received from options exercised for the year ended December 31, 2010 was \$219,000, with a related tax benefit of \$28,000.

Total compensation costs recorded for RSUs, stock options and restricted stock awards were \$1.3 million, \$926,000, and \$862,000 for 2011, 2010 and 2009, respectively. As of December 31, 2011, there was \$2.6 million of total unrecognized compensation costs related to the 2005 Long-Term Incentive Plan for RSUs and stock options which is expected to be recognized through 2015. In addition, for the years ended December 31, 2011, 2010 and 2009, the shares of stock awarded to Heartland directors in return for services performed were 5,200, 5,000, and 5,000, respectively. The related compensation expense recorded was \$83,000, \$87,000, and \$84,000 for the respective years.

At Heartland's annual meeting of stockholders on May 18, 2005, the 2006 Employee Stock Purchase Plan (the "2006 ESPP"), was adopted, effective January 1, 2006. The 2006 ESPP permits all eligible employees to purchase shares of Heartland common stock at a price of not less than 85% of the fair market value on the determination date (as determined by the Compensation Committee). A maximum of 500,000 shares is available for sale under the 2006 ESPP. For the year ended December 31, 2011, Heartland approved a purchase price of 100% of fair market value as determined by the closing price on December 31, 2010. For the year ended December 31, 2010, Heartland approved a purchase price of 100% of fair market value as determined by the closing price on December 31, 2009. At December 31, 2011, 3,500 shares were purchased under the 2006 ESPP and at December 31, 2010, 19,360 shares were purchased under the 2006 ESPP. Under ASC Topic 718, compensation expense of \$39,000 was recorded in 2011 and \$73,000 was recorded in 2010, because the price of the shares purchased was set at the beginning of the year for the purchases at the end of the year.

## **SIXTEEN**

### **STOCKHOLDER RIGHTS PLAN**

On June 7, 2002, Heartland adopted a stockholders' rights plan (the "Rights Plan"). Under the terms of the Rights Plan, on June 26, 2002, the Board of Directors distributed one purchase right for each share of common stock outstanding as of June 24, 2002. Upon becoming exercisable, each right entitles the registered holder thereof, under certain limited circumstances, to purchase one-thousandth of a share of Series A Junior Participating preferred stock at an exercise price of \$85.00. Rights do not become exercisable until ten business days after any person or group has acquired, commenced, or announced its intention to commence a tender or exchange offer to acquire 15% or more of Heartland's common stock. If the rights become exercisable, holders of each right, other than the acquirer, upon payment of the exercise price, will have the right to purchase Heartland's common stock (in lieu of preferred shares) having a value equal to two times the exercise price. If Heartland is acquired in a merger, share exchange or other business combination or 50% or more of its consolidated assets or earning power are sold, rights holders, other than the acquiring or adverse person or group, will be entitled to purchase the acquirer's shares at a similar discount. If the rights become exercisable, Heartland may also exchange rights, other than those held by the acquiring or adverse person or group, in whole or in part, at an exchange ratio of one share of Heartland's common stock per right held. Rights are redeemable by Heartland at any time until they are exercisable at the exchange rate of \$.01 per right. Issuance of the rights has no immediate dilutive effect, does not currently affect reported earnings per share, is not taxable to Heartland or its stockholders, and will not change the way in which Heartland's shares are traded. The rights expire on June 7, 2012.

In connection with the Rights Plan, Heartland designated 16,000 shares, par value \$1.00 per share, of Series A Junior Participating preferred stock. These shares, if issued, will be entitled to receive quarterly dividends and a liquidation preference. There are no shares issued and outstanding and Heartland does not anticipate issuing any shares of Series A Junior Participating preferred stock except as may be required under the Rights Plan.

## **SEVENTEEN**

### **CAPITAL ISSUANCE AND REDEMPTION**

On September 15, 2011, Heartland entered into a Securities Purchase Agreement ("Purchase Agreement") with the Secretary of the Treasury ("Treasury"), pursuant to which Heartland issued and sold to Treasury 81,698 shares of its Senior Non-Cumulative Perpetual Preferred Stock, Series C ("Series C Preferred Stock"), having a liquidation preference of \$1,000 per share ("Liquidation Amount"), for aggregate proceeds of \$81.7 million. The issuance was made pursuant to the Small Business Lending Fund ("SBLF"), a \$30 billion fund established under the Small Business Jobs Act of 2010 that encourages lending to small businesses by providing capital to qualified community banks with assets of less than \$10 billion.

The Series C Preferred Stock qualifies as Tier 1 capital for Heartland. Non-cumulative dividends are payable quarterly on the Series C Preferred Stock, beginning October 1, 2011. The dividend rate is calculated as a percentage of the aggregate Liquidation Amount of the outstanding Series C Preferred Stock and is based on changes in the level of Qualified Small Business Lending or ("QSBL"). Based upon Heartland's level of QSBL compared to the baseline level calculated under the terms of the Purchase Agreement, the dividend rate for the initial dividend period, which is from the date of issuance through September 30, 2011, has been set at 5%. For the 2nd through 10th calendar quarters, the annual dividend rate may be adjusted to between 1.00% and 5.00%, to reflect the amount of change in Heartland's level of QSBL. For the 11th calendar quarter (starting January 1, 2014) through 4.5 years after issuance (March 15, 2016), the dividend rate will be fixed at between 1.00% and 7.00% based upon the increase in QSBL as compared to the baseline. In addition, if there has been no increase in QSBL, then Heartland will be obligated to pay a quarterly lending incentive fee starting on the fifth annual anniversary after it received CPP funds (January 1, 2014) and ending on March 31, 2016, of 0.50% per quarter, or 2.00% per year (aggregate dividends and fees of 9.00%). After 4.5 years from issuance (March 15, 2016), the dividend rate will increase to 9.00%.

The Series C Preferred Stock is non-voting, except in limited circumstances. In the event that Heartland misses five dividend payments, whether or not consecutive, the holder of the Series C Preferred Stock will have the right, but not the obligation, to appoint a representative as an observer on Heartland's Board of Directors. In the event that Heartland misses six dividend payments, whether or not consecutive, and if the then outstanding aggregate Liquidation Amount of the Series C Preferred Stock is at least \$25.0 million, then the holder of the Series C Preferred Stock will have the right to designate two directors to the Board of Directors of Heartland. Heartland may redeem the shares of Series C Preferred Stock, in whole or in part, at any time at a redemption price equal to the sum of the Liquidation Amount per share and the per share amount of any unpaid dividends for the then-current period, subject to any required prior approval by Heartland's primary federal banking regulator.

The terms of the Series C Preferred Stock impose limits on Heartland's ability to pay dividends on and repurchase shares of its common stock and other securities. In general, Heartland may declare and pay dividends on its common stock or any other stock junior to the Series C Preferred Stock, or repurchase shares of any such stock, only if after payment of such dividends or repurchase of such shares Heartland's Tier 1 Capital would be at least 90% of the difference between \$312.5 million (the Tier 1 Capital on the signing date) and any subsequent net charge-offs (the "Tier 1 Dividend Threshold"). The Tier 1 Dividend Threshold is subject to reduction on or after January 1, 2014 by 10% for each one percent increase in Heartland's QSBL over the baseline level through September 30, 2013. If, however Heartland fails to declare and pay dividends on the Series C Preferred Stock in a given quarter, then during such quarter and for the next three quarters following such missed dividend payment Heartland may not pay dividends on or repurchase any common stock or any other securities that are junior to (or in parity with) the Series C Preferred Stock, except in very limited circumstances. If any Series C Preferred Stock remains outstanding on the 10th anniversary of issuance, Heartland may not pay any further dividends on its common stock or any other junior stock until the Series C Preferred Stock is redeemed in full.

On September 15, 2011, Heartland entered into a letter agreement ("Repurchase Document") with Treasury, pursuant to which, Heartland redeemed from Treasury, in part using the proceeds from the issuance of the Series C Preferred Stock, all 81,698 outstanding shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series B ("Series B Preferred Stock"), for a redemption price of \$82.0 million, including accrued but unpaid dividends to the date of redemption. As a result of its redemption of the Series B Preferred Stock, Heartland is no longer subject to the limits provided for under the TARP Capital Purchase Program with respect to future executive compensation decisions and other matters. When the Series B Preferred Stock was issued, \$6.3 million of the \$81.7 million purchase price was assigned to the associated Warrant and the remaining \$75.4 million was assigned to the carrying value of the Series B Preferred Stock. The \$6.3 million discount was being amortized over five years, the anticipated life of the Series B Preferred Stock. Upon redemption of the Series B Preferred Stock, \$2.6 million of the remaining unamortized discount was recognized.

On September 28, 2011, Heartland repurchased from Treasury a warrant to purchase 609,687 shares of Heartland common stock, \$1.00 par value per share, at an exercise price of \$20.10 per share ("Warrant"), issued to Treasury on December 19, 2008, in connection with participation in the TARP Capital Purchase Program. Heartland paid an aggregate purchase price of \$1.8 million for the repurchase of the Warrant, which has been cancelled.

## **EIGHTEEN**

### **REGULATORY CAPITAL REQUIREMENTS AND RESTRICTIONS ON SUBSIDIARY DIVIDENDS**

The Heartland banks are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Heartland banks' financial statements. The regulations prescribe specific capital adequacy guidelines that involve quantitative measures of a bank's assets, liabilities and certain off balance sheet items as calculated under regulatory accounting practices. Capital classification is also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Heartland banks to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2011 and 2010, that the Heartland banks met all capital adequacy requirements to which they were subject.

As of December 31, 2011 and 2010, the FDIC categorized each of the Heartland banks as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Heartland banks must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since that notification that management believes have changed each institution's category.

The Heartland banks' actual capital amounts and ratios are also presented in the table below:

(Dollars in thousands)

|   | Actual            |               | For Capital Adequacy Purposes |              | To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|---|-------------------|---------------|-------------------------------|--------------|--|--------|
|   | Amount            | Ratio         | Amount                        | Ratio        | Amount   | Ratio  |
| <b>As of December 31, 2011</b>                  |                   |               |                               |              |  |        |
| <b>Total Capital (to Risk-Weighted Assets)</b>  |                   |               |                               |              |  |        |
| <b>Consolidated</b>                             | <b>\$ 481,513</b> | <b>15.87%</b> | <b>\$ 242,715</b>             | <b>8.00%</b> | <b>N/A</b>   |        |
| Dubuque Bank and Trust Company                  | 125,478           | 12.55         | 79,962                        | 8.00         | 99,953   | 10.00% |
| Galena State Bank & Trust Co.                   | 26,354            | 13.34         | 15,804                        | 8.00         | 19,755   | 10.00  |
| Riverside Community Bank                        | 27,636            | 13.83         | 15,982                        | 8.00         | 19,978   | 10.00  |
| Wisconsin Community Bank                        | 50,475            | 14.77         | 27,348                        | 8.00         | 34,185   | 10.00  |
| New Mexico Bank & Trust                         | 85,006            | 13.45         | 50,560                        | 8.00         | 63,200   | 10.00  |
| Arizona Bank & Trust                            | 21,045            | 12.10         | 13,913                        | 8.00         | 17,392   | 10.00  |
| Rocky Mountain Bank                             | 48,182            | 16.16         | 23,859                        | 8.00         | 29,823   | 10.00  |
| Summit Bank & Trust                             | 12,170            | 16.03         | 6,075                         | 8.00         | 7,594  | 10.00  |
| Minnesota Bank & Trust                          | 13,878            | 20.63         | 5,381                         | 8.00         | 6,726  | 10.00  |
| <b>Tier 1 Capital (to Risk-Weighted Assets)</b> |                   |               |                               |              |  |        |
| <b>Consolidated</b>                             | <b>\$ 427,145</b> | <b>14.08%</b> | <b>\$ 121,357</b>             | <b>4.00%</b> | <b>N/A</b>   |        |
| Dubuque Bank and Trust Company                  | 116,103           | 11.62         | 39,981                        | 4.00         | 59,972   | 6.00%  |
| Galena State Bank & Trust Co.                   | 24,511            | 12.41         | 7,902                         | 4.00         | 11,853   | 6.00   |
| Riverside Community Bank                        | 25,134            | 12.58         | 7,991                         | 4.00         | 11,987   | 6.00   |
| Wisconsin Community Bank                        | 46,989            | 13.75         | 13,674                        | 4.00         | 20,511   | 6.00   |
| New Mexico Bank & Trust                         | 78,345            | 12.40         | 25,280                        | 4.00         | 37,920   | 6.00   |
| Arizona Bank & Trust                            | 18,814            | 10.82         | 6,957                         | 4.00         | 10,435   | 6.00   |
| Rocky Mountain Bank                             | 44,452            | 14.91         | 11,929                        | 4.00         | 17,894   | 6.00   |
| Summit Bank & Trust                             | 11,220            | 14.78         | 3,038                         | 4.00         | 4,556  | 6.00   |
| Minnesota Bank & Trust                          | 13,290            | 19.76         | 2,690                         | 4.00         | 4,036  | 6.00   |
| <b>Tier 1 Capital (to Average Assets)</b>       |                   |               |                               |              |  |        |
| <b>Consolidated</b>                             | <b>\$ 427,145</b> | <b>10.24%</b> | <b>\$ 166,865</b>             | <b>4.00%</b> | <b>N/A</b>   |        |
| Dubuque Bank and Trust Company                  | 116,103           | 8.77          | 52,961                        | 4.00         | 66,201   | 5.00%  |
| Galena State Bank & Trust Co.                   | 24,511            | 8.41          | 11,654                        | 4.00         | 14,568   | 5.00   |
| Riverside Community Bank                        | 25,134            | 7.78          | 12,922                        | 4.00         | 16,152   | 5.00   |
| Wisconsin Community Bank                        | 46,989            | 9.57          | 19,634                        | 4.00         | 24,542   | 5.00   |
| New Mexico Bank & Trust                         | 78,345            | 8.47          | 37,010                        | 4.00         | 46,263   | 5.00   |
| Arizona Bank & Trust                            | 18,814            | 8.50          | 8,849                         | 4.00         | 11,062   | 5.00   |
| Rocky Mountain Bank                             | 44,452            | 10.50         | 16,938                        | 4.00         | 21,173   | 5.00   |
| Summit Bank & Trust                             | 11,220            | 11.72         | 3,830                         | 4.00         | 4,787  | 5.00   |
| Minnesota Bank & Trust                          | 13,290            | 16.53         | 3,215                         | 4.00         | 4,019  | 5.00   |

(Dollars in thousands)

|   | Actual            |               | For Capital Adequacy Purposes |              | To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|---|-------------------|---------------|-------------------------------|--------------|--|--------|
|   | Amount            | Ratio         | Amount                        | Ratio        | Amount   | Ratio  |
| <b>As of December 31, 2010</b>                  |                   |               |                               |              |  |        |
| <b>Total Capital (to Risk-Weighted Assets)</b>  |                   |               |                               |              |  |        |
| <b>Consolidated</b>                             | <b>\$ 465,666</b> | <b>16.23%</b> | <b>\$ 229,521</b>             | <b>8.00%</b> | <b>N/A</b>   |        |
| Dubuque Bank and Trust Company                  | 110,860           | 13.26         | 66,867                        | 8.00         | 83,584   | 10.00% |
| Galena State Bank & Trust Co.                   | 25,194            | 14.47         | 13,929                        | 8.00         | 17,411   | 10.00  |
| First Community Bank                            | 11,226            | 16.12         | 5,570                         | 8.00         | 6,962  | 10.00  |
| Riverside Community Bank                        | 26,616            | 13.75         | 15,490                        | 8.00         | 19,363   | 10.00  |
| Wisconsin Community Bank                        | 48,634            | 13.51         | 28,798                        | 8.00         | 35,998   | 10.00  |
| New Mexico Bank & Trust                         | 80,422            | 12.87         | 50,006                        | 8.00         | 62,507   | 10.00  |
| Arizona Bank & Trust                            | 24,562            | 15.67         | 12,543                        | 8.00         | 15,679   | 10.00  |
| Rocky Mountain Bank                             | 46,474            | 15.68         | 23,706                        | 8.00         | 29,632   | 10.00  |
| Summit Bank & Trust                             | 12,483            | 19.63         | 5,088                         | 8.00         | 6,360  | 10.00  |
| Minnesota Bank & Trust                          | 13,926            | 31.51         | 3,536                         | 8.00         | 4,420  | 10.00  |
| <b>Tier 1 Capital (to Risk-Weighted Assets)</b> |                   |               |                               |              |  |        |
| <b>Consolidated</b>                             | <b>\$ 403,357</b> | <b>14.06%</b> | <b>\$ 114,760</b>             | <b>4.00%</b> | <b>N/A</b>   |        |
| Dubuque Bank and Trust Company                  | 100,408           | 12.01         | 33,433                        | 4.00         | 50,150   | 6.00%  |
| Galena State Bank & Trust Co.                   | 23,370            | 13.42         | 6,965                         | 4.00         | 10,447   | 6.00   |
| First Community Bank                            | 10,346            | 14.86         | 2,785                         | 4.00         | 4,177  | 6.00   |
| Riverside Community Bank                        | 24,182            | 12.49         | 7,745                         | 4.00         | 11,618   | 6.00   |
| Wisconsin Community Bank                        | 44,761            | 12.43         | 14,399                        | 4.00         | 21,599   | 6.00   |
| New Mexico Bank & Trust                         | 72,676            | 11.63         | 25,003                        | 4.00         | 37,504   | 6.00   |
| Arizona Bank & Trust                            | 22,539            | 14.38         | 6,272                         | 4.00         | 9,407  | 6.00   |
| Rocky Mountain Bank                             | 42,769            | 14.43         | 11,853                        | 4.00         | 17,779   | 6.00   |
| Summit Bank & Trust                             | 11,682            | 18.37         | 2,544                         | 4.00         | 3,816  | 6.00   |
| Minnesota Bank & Trust                          | 13,373            | 30.26         | 1,768                         | 4.00         | 2,652  | 6.00   |
| <b>Tier 1 Capital (to Average Assets)</b>       |                   |               |                               |              |  |        |
| <b>Consolidated</b>                             | <b>\$ 403,357</b> | <b>9.92%</b>  | <b>\$ 162,580</b>             | <b>4.00%</b> | <b>N/A</b>   |        |
| Dubuque Bank and Trust Company                  | 100,408           | 8.33          | 48,209                        | 4.00         | 60,261   | 5.00%  |
| Galena State Bank & Trust Co.                   | 23,370            | 8.27          | 11,302                        | 4.00         | 14,128   | 5.00   |
| First Community Bank                            | 10,346            | 8.94          | 4,627                         | 4.00         | 5,784  | 5.00   |
| Riverside Community Bank                        | 24,182            | 8.12          | 11,911                        | 4.00         | 14,889   | 5.00   |
| Wisconsin Community Bank                        | 44,761            | 9.56          | 18,730                        | 4.00         | 23,412   | 5.00   |
| New Mexico Bank & Trust                         | 72,676            | 8.01          | 36,290                        | 4.00         | 45,362   | 5.00   |
| Arizona Bank & Trust                            | 22,539            | 9.45          | 9,539                         | 4.00         | 11,923   | 5.00   |
| Rocky Mountain Bank                             | 42,769            | 10.02         | 17,065                        | 4.00         | 21,332   | 5.00   |
| Summit Bank & Trust                             | 11,682            | 12.07         | 3,870                         | 4.00         | 4,838  | 5.00   |
| Minnesota Bank & Trust                          | 13,373            | 23.59         | 2,267                         | 4.00         | 2,834  | 5.00   |

The ability of Heartland to pay dividends to its stockholders is dependent upon dividends paid by its subsidiaries. The Heartland banks are subject to certain statutory and regulatory restrictions on the amount they may pay in dividends. To maintain acceptable capital ratios in the Heartland banks, certain portions of their retained earnings are not available for the payment of dividends. Retained earnings that could be available for the payment of dividends to Heartland totaled approximately \$125.3 million as of December 31, 2011, under the most restrictive minimum capital requirements. Retained earnings that could be available for the payment of dividends to Heartland totaled approximately \$77.9 million as of December 31, 2011, under the capital requirements to remain well capitalized.

## **NINETEEN**

### **FAIR VALUE OF FINANCIAL INSTRUMENTS**

As discussed in Note 1, ASC 820 defines fair value, establishes a framework for measuring fair value and expands the required disclosure about fair value measurements. 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 nonrecurring 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 ASC 820, 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 where 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. The Level 3 securities consist primarily of \$3.1 million of Z tranche assets.

##### *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. Once a loan is identified as individually impaired, management measures impairment in accordance with ASC 310, "*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. At December 31, 2011, substantially all of the total impaired loans were based on the fair value of the collateral. In accordance with ASC 820, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. Heartland classifies its impaired loans as nonrecurring Level 3.

### *Derivative Financial Instruments*

Currently, Heartland uses interest rate caps, floors, collars and certain interest rate lock commitments and forward sales of securities related to mortgage banking activities to manage its interest rate risk. The valuation of interest rate-related 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 ASC 820, 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 interest-rate related 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 December 31, 2011, and December 31, 2010, 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 derivatives include interest rate lock commitments to originate residential mortgage loans held for sale to individual customers and forward commitments to sell residential mortgage loans to various investors. Heartland relies on an internal valuation model to estimate the fair value of interest rate lock commitments to originate residential mortgage loans held for sale, which includes grouping the interest rate lock commitments by interest rate and terms, applying an estimated pull-through rate based on historical experience, and then multiplying by quoted investor prices determined to be reasonably applicable to the loan commitment group based on interest rate, term, and rate lock expiration dates of the loan commitment groups.

Heartland also relies on an internal valuation model to estimate the fair value of forward commitments to sell residential mortgage loans. The model includes inputs such as the estimate of what Heartland would receive or pay to terminate the forward delivery contract based on market prices for similar financial instruments. This also includes matching specific terms and maturities of the forward commitments against applicable investor pricing when available. While there are both Level 2 and 3 inputs used in the valuation models, Heartland feels that the majority of the inputs significant in the valuation of both of the mortgage derivatives fall within the Level 3 category of the fair value hierarchy. See Note 11 for additional disclosure regarding mortgage derivatives.

### *Other Real Estate*

Other real estate ("OREO") represents property acquired through foreclosures and settlements of loans. Property acquired is carried at the lower of the principal amount of the loan outstanding at the time of acquisition, plus any acquisition costs, or the estimated fair value of the property, less disposal costs. Heartland considers third party appraisals as well as independent fair value assessments from realtors or persons involved in selling OREO in determining the fair value of particular properties. Accordingly, the valuation of OREO is subject to significant external and internal judgment. Heartland also periodically reviews OREO to determine whether the property continues to be carried at the lower of its recorded book value or fair value of the property, less disposal costs. OREO is classified as nonrecurring Level 3.



The table below presents, Heartland's assets and liabilities that are measured at fair value on a recurring basis as of December 31, 2011, and December 31, 2010, aggregated by the level in the fair value hierarchy within which those measurements fall:

(Dollars in thousands)

|                                   | <b>Total Fair Value<br/>Dec. 31, 2011</b> | <b>Level 1</b>    | <b>Level 2</b>      | <b>Level 3</b>  |
|-----------------------------------|---|-------------------|---------------------|-----------------|
| Trading securities                | \$ 333                                    | \$ 333            | \$ —                | \$ —            |
| Available-for-sale securities     | 1,267,999                                 | 107,147           | 1,157,609           | 3,243           |
| <b>Total assets at fair value</b> | <b>\$ 1,268,332</b>                       | <b>\$ 107,480</b> | <b>\$ 1,157,609</b> | <b>\$ 3,243</b> |

|                                   | <b>Total Fair Value<br/>Dec. 31, 2010</b> | <b>Level 1</b>    | <b>Level 2</b>    | <b>Level 3</b>  |
|-----------------------------------|---|-------------------|-------------------|-----------------|
| Trading securities                | \$ 244                                    | \$ 244            | \$ —              | \$ —            |
| Available-for-sale securities     | 1,204,699                                 | 320,008           | 880,015           | 4,676           |
| <b>Total assets at fair value</b> | <b>\$ 1,204,943</b>                       | <b>\$ 320,252</b> | <b>\$ 880,015</b> | <b>\$ 4,676</b> |

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

(Dollars in thousands)

|  | <b>For the Year Ended<br/>December 31, 2011</b> | <b>For the Year Ended<br/>December 31, 2010</b> |
|--|---|---|
|  | <b>Fair Value</b>                               | <b>Fair Value</b>                               |
| Balance at January 1,                    | \$ 4,676  | \$ 1,535  |
| Purchases                                | —   | —   |
| Redemptions                              | (1,406)   | (45)  |
| Market value appreciation (depreciation) | (27)  | 3,186   |
| <b>Balance at December 31,</b>           | <b>\$ 3,243</b>                                 | <b>\$ 4,676</b>                                 |

The table below presents Heartland's assets measured at fair value on a nonrecurring basis:

(Dollars in thousands)

|                | <b>Carrying Value at December 31, 2011</b> |                |                |                | <b>Year Ended<br/>December 31, 2011</b> |
|----------------|--|----------------|----------------|----------------|---|
|                | <b>Total</b>                               | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> | <b>Total Losses</b>                     |
| Impaired loans | \$ 94,961                                  | \$ —           | \$ —           | \$ 94,961      | \$ 32,640                               |
| OREO           | 44,387                                     | —              | —              | 44,387         | 7,079                                   |

|                | <b>Carrying Value at December 31, 2010</b> |                |                |                | <b>Year Ended<br/>December 31, 2010</b> |
|----------------|--|----------------|----------------|----------------|---|
|                | <b>Total</b>                               | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> | <b>Total Losses</b>                     |
| Impaired loans | \$ 147,184                                 | \$ —           | \$ —           | \$ 147,184     | \$ 27,492                               |
| OREO           | 32,002                                     | —              | —              | 32,002         | 11,711                                  |

The table below is a summary of the estimated fair value of Heartland's financial instruments as of December 31, 2011 and 2010 as defined by ASC 825. The carrying amounts in the following table are recorded in the balance sheet under the indicated captions. In accordance with ASC 825, the assets and liabilities that are not financial instruments are not included in the disclosure, such as the value of the mortgage servicing rights, premises, furniture and equipment, goodwill and other intangibles and other liabilities.

Heartland does not believe that the estimated information presented below is representative of the earnings power or value of Heartland. The following analysis, which is inherently limited in depicting fair value, also does not consider any value

associated with existing customer relationships nor the ability of Heartland to create value through loan origination, deposit gathering or fee generating activities. Many of the estimates presented below are based upon the use of highly subjective information and assumptions and, accordingly, the results may not be precise. Management believes that fair value estimates may not be comparable between financial institutions due to the wide range of permitted valuation techniques and numerous estimates which must be made. Furthermore, because the disclosed fair value amounts were estimated as of the balance sheet date, the amounts actually realized or paid upon maturity or settlement of the various financial instruments could be significantly different.

(Dollars in thousands)

|  | December 31, 2011 |            | December 31, 2010 |            |
|--|-------------------|------------|-------------------|------------|
|  | Carrying Amount   | Fair Value | Carrying Amount   | Fair Value |
| <b>Financial Assets:</b>                           |                   |            |                   |            |
| Cash and cash equivalents                          | \$ 129,834        | \$ 129,834 | \$ 62,572         | \$ 62,572  |
| Trading securities                                 | 333               | 333        | 244               | 244        |
| Securities available for sale                      | 1,267,999         | 1,267,999  | 1,204,699         | 1,204,699  |
| Securities held to maturity                        | 58,260            | 57,486     | 59,621            | 58,610     |
| Loans held for sale                                | 53,528            | 53,999     | 23,904            | 23,904     |
| Loans and leases held to maturity, net of unearned | 2,494,631         | 2,488,881  | 2,364,787         | 2,370,933  |
| Mortgage derivatives                               | 2,828             | 2,828      | —                 | —          |
| <b>Financial Liabilities:</b>                      |                   |            |                   |            |
| Demand deposits                                    | \$ 737,323        | \$ 737,323 | \$ 580,589        | \$ 580,589 |
| Savings deposits                                   | 1,678,154         | 1,678,154  | 1,558,998         | 1,558,998  |
| Time deposits                                      | 794,636           | 794,636    | 894,461           | 894,461    |
| Short-term borrowings                              | 270,081           | 270,081    | 235,864           | 235,864    |
| Other borrowings                                   | 372,820           | 352,847    | 362,527           | 347,749    |
| Derivatives  | 6,185             | 6,185      | 2,122             | 2,122      |

**Cash and Cash Equivalents** - The carrying amount is a reasonable estimate of fair value due to the short-term nature of these instruments.

**Securities** - For securities either held to maturity, available for sale or trading, fair value equals quoted market price if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

**Loans and Leases** - The fair value of loans is estimated using a historical or replacement cost basis concept (i.e. an entrance price concept). The fair value of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. The fair value of loans held for sale is estimated using quoted market prices.

**Deposits** - The fair value of demand deposits, savings accounts and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities. If the fair value of the fixed maturity certificates of deposits is calculated at less than the carrying amount, the carrying value of these deposits is reported as the fair value.

**Short-term and Other Borrowings** - Rates currently available to Heartland for debt with similar terms and remaining maturities are used to estimate fair value of existing debt.

**Derivatives** - The fair value of all derivatives was estimated based on the amount that Heartland would pay or would be paid to terminate the contract or agreement, using current rates and, when appropriate, the current creditworthiness of the counterparty.

**Commitments to Extend Credit, Unused Lines of Credit and Standby Letters of Credit** - Based upon management's analysis of the off balance sheet financial instruments, there are no significant unrealized gains or losses associated with these financial instruments based upon our review of the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties.

**TWENTY**  
**PARENT COMPANY ONLY FINANCIAL INFORMATION**

Condensed financial information for Heartland Financial USA, Inc. is as follows:

**BALANCE SHEETS**

(Dollars in thousands)

|  | <b>December 31,</b> |                   |
|--|---------------------|-------------------|
|  | <b>2011</b>         | <b>2010</b>       |
| <b>Assets:</b>                               |                     |                   |
| Cash and interest bearing deposits           | \$ 26,960           | \$ 17,365         |
| Trading securities                           | 333                 | 244               |
| Securities available for sale                | 4,858               | 6,365             |
| Investment in subsidiaries                   | 460,946             | 435,224           |
| Other assets                                 | 22,140              | 19,970            |
| Due from subsidiaries                        | 2,750               | 2,750             |
| Total assets                                 | <u>\$ 517,987</u>   | <u>\$ 481,918</u> |
| <b>Liabilities and stockholders' equity:</b> |                     |                   |
| Short-term borrowings                        | \$ —                | \$ 5,000          |
| Other borrowings                             | 155,126             | 140,899           |
| Accrued expenses and other liabilities       | 12,643              | 6,928             |
| Total liabilities                            | <u>167,769</u>      | <u>152,827</u>    |
| <b>Stockholders' equity:</b>                 |                     |                   |
| Preferred stock                              | 81,698              | 78,483            |
| Common stock                                 | 16,612              | 16,612            |
| Capital surplus                              | 43,333              | 44,628            |
| Retained earnings                            | 198,182             | 184,525           |
| Accumulated other comprehensive income       | 12,147              | 8,517             |
| Treasury stock                               | (1,754)             | (3,674)           |
| Total stockholders' equity                   | <u>350,218</u>      | <u>329,091</u>    |
| Total liabilities and stockholders' equity   | <u>\$ 517,987</u>   | <u>\$ 481,918</u> |

## INCOME STATEMENTS

(Dollars in thousands)

|   | For the years ended December 31, |           |           |
|---|----------------------------------|-----------|-----------|
|   | 2011                             | 2010      | 2009      |
| <b>Operating revenues:</b>                  |                                  |           |           |
| Dividends from subsidiaries                 | \$ 26,400                        | \$ 19,700 | \$ 12,000 |
| Securities gains, net                       | 1,424                            | 101       | 2,405     |
| Gain (loss) on trading account securities   | 89                               | (91)      | 211       |
| Impairment loss on equity securities        | —                                | —         | (40)      |
| Other                                       | 476                              | 671       | 1,734     |
| Total operating revenues                    | 28,389                           | 20,381    | 16,310    |
| <b>Operating expenses:</b>                  |                                  |           |           |
| Interest                                    | 9,113                            | 7,499     | 6,104     |
| Salaries and benefits                       | 5,741                            | 2,800     | 957       |
| Professional fees                           | 2,498                            | 694       | 547       |
| Other operating expenses                    | 3,146                            | 3,075     | 717       |
| Total operating expenses                    | 20,498                           | 14,068    | 8,325     |
| Equity in undistributed earnings (loss)     | 12,852                           | 12,605    | (3,055)   |
| Income before income tax benefit            | 20,743                           | 18,918    | 4,930     |
| Income tax benefit                          | 7,301                            | 4,985     | 1,632     |
| Net income                                  | 28,044                           | 23,903    | 6,562     |
| Preferred dividends and discount            | (7,640)                          | (5,344)   | (5,344)   |
| Net income available to common stockholders | \$ 20,404                        | \$ 18,559 | \$ 1,218  |

## STATEMENTS OF CASH FLOWS

(Dollars in thousands)

|   | For the years ended December 31, |           |          |
|---|----------------------------------|-----------|----------|
|   | 2011                             | 2010      | 2009     |
| <b>Cash flows from operating activities:</b>  |                                  |           |          |
| Net income  | \$ 28,044                        | \$ 23,903 | \$ 6,562 |
| Adjustments to reconcile net income to net cash provided by operating activities:     |                                  |           |          |
| Undistributed loss (earnings) of subsidiaries   | (12,852)                         | (12,605)  | 3,055    |
| Security gains, net   | (1,424)                          | (101)     | (2,405)  |
| Impairment loss on securities   | —                                | —         | 40       |
| Decrease in due from subsidiaries   | —                                | 2,000     | 10,750   |
| Increase in accrued expenses and other liabilities                                    | 5,714                            | 897       | 9        |
| (Increase) decrease in other assets   | (2,157)                          | (5,443)   | 1,227    |
| (Increase) decrease in trading account securities                                     | (89)                             | 451       | 997      |
| Other, net  | (442)                            | (2,354)   | 987      |
| Net cash provided by operating activities   | 16,794                           | 6,748     | 21,222   |
| <b>Cash flows from investing activities:</b>  |                                  |           |          |
| Capital contributions to subsidiaries   | (6,000)                          | (21,047)  | (43,720) |
| Purchases of available for sale securities  | —                                | (8,101)   | (2,919)  |
| Proceeds from the maturity of and principal paydowns on securities available for sale | —                                | 1,644     | 33,332   |
| Proceeds from sales of available for sale securities                                  | 1,507                            | 16,814    | —        |
| Net cash used by investing activities   | (4,493)                          | (10,690)  | (13,307) |
| <b>Cash flows from financing activities:</b>  |                                  |           |          |
| Net change in short-term borrowings   | (5,000)                          | —         | 5,000    |
| Proceeds from other borrowings  | 18,165                           | 24,844    | —        |
| Repayments of other borrowings  | (3,938)                          | (240)     | (792)    |
| Proceeds from issuance of preferred stock   | 81,698                           | —         | —        |
| Payment for the repurchase of preferred stock   | (81,698)                         | —         | —        |
| Redemption of warrant   | (1,800)                          | —         | —        |
| Cash dividends paid   | (11,172)                         | (10,606)  | (10,182) |
| Purchase of treasury stock  | (389)                            | (212)     | (236)    |
| Proceeds from issuance of common stock  | 1,428                            | 1,360     | 970      |
| Net cash provided (used) by financing activities                                      | (2,706)                          | 15,146    | (5,240)  |
| Net increase in cash and cash equivalents   | 9,595                            | 11,204    | 2,675    |
| Cash and cash equivalents at beginning of year  | 17,365                           | 6,161     | 3,486    |
| Cash and cash equivalents at end of year  | \$ 26,960                        | \$ 17,365 | \$ 6,161 |

**TWENTY-ONE**  
**SUMMARY OF QUARTERLY FINANCIAL INFORMATION (UNAUDITED)**

(Dollars in thousands, except per share data)

| <b>2011</b>   | <b>Dec. 31</b> | <b>Sept. 30</b> | <b>June 30</b> | <b>March 31</b> |
|---|----------------|-----------------|----------------|-----------------|
| Net interest income   | \$ 36,837      | \$ 36,235       | \$ 36,601      | \$ 35,721       |
| Provision for loan and lease losses                           | 7,784          | 7,727           | 3,845          | 10,009          |
| Net interest income after provision for loan and lease losses | 29,053         | 28,508          | 32,756         | 25,712          |
| Noninterest income  | 19,038         | 13,262          | 14,669         | 12,608          |
| Noninterest expense   | 40,203         | 31,863          | 32,343         | 32,887          |
| Income taxes  | 1,671          | 2,549           | 4,870          | 1,212           |
| Net income  | 6,217          | 7,358           | 10,212         | 4,221           |
| Net income available to noncontrolling interest, net of tax   | 31             | (20)            | 9              | 16              |
| Net income attributable to Heartland                          | 6,248          | 7,338           | 10,221         | 4,237           |
| Preferred stock dividends and discount                        | (1,021)        | (3,947)         | (1,336)        | (1,336)         |
| Net income available to common stockholders                   | 5,227          | 3,391           | 8,885          | 2,901           |
| Per share:  |                |                 |                |                 |
| Earnings per share-basic                                      | \$ 0.32        | \$ 0.21         | \$ 0.54        | \$ 0.18         |
| Earnings per share-diluted                                    | 0.31           | 0.20            | 0.54           | 0.18            |
| Cash dividends declared on common stock                       | 0.10           | 0.10            | 0.10           | 0.10            |
| Book value per common share                                   | 16.29          | 16.33           | 16.04          | 15.28           |
| Weighted average common shares outstanding                    | 16,460,613     | 16,444,369      | 16,426,741     | 16,407,845      |
| Weighted average diluted common shares outstanding            | 16,599,741     | 16,585,021      | 16,568,701     | 16,557,353      |

(Dollars in thousands, except per share data)

| <b>2010</b>   | <b>Dec. 31</b> | <b>Sept. 30</b> | <b>June 30</b> | <b>March 31</b> |
|---|----------------|-----------------|----------------|-----------------|
| Net interest income   | \$ 35,846      | \$ 36,713       | \$ 35,809      | \$ 34,684       |
| Provision for loan and lease losses                           | 8,860          | 4,799           | 9,955          | 8,894           |
| Net interest income after provision for loan and lease losses | 26,986         | 31,914          | 25,854         | 25,790          |
| Noninterest income  | 18,293         | 12,609          | 10,834         | 10,593          |
| Noninterest expense   | 37,317         | 33,446          | 29,575         | 28,901          |
| Income taxes  | 1,464          | 4,187           | 2,035          | 2,160           |
| Net income  | 6,498          | 6,890           | 5,078          | 5,322           |
| Net income available to noncontrolling interest, net of tax   | 35             | 30              | 25             | 25              |
| Net income attributable to Heartland                          | 6,533          | 6,920           | 5,103          | 5,347           |
| Preferred stock dividends and discount                        | (1,336)        | (1,336)         | (1,336)        | (1,336)         |
| Net income available to common stockholders                   | 5,197          | 5,584           | 3,767          | 4,011           |
| Per share:  |                |                 |                |                 |
| Earnings per share-basic                                      | \$ 0.32        | \$ 0.34         | \$ 0.23        | \$ 0.25         |
| Earnings per share-diluted                                    | 0.31           | 0.34            | 0.23           | 0.24            |
| Cash dividends declared on common stock                       | 0.10           | 0.10            | 0.10           | 0.10            |
| Book value per common share                                   | 15.26          | 15.58           | 15.08          | 14.40           |
| Weighted average common shares outstanding                    | 16,392,806     | 16,380,606      | 16,363,106     | 16,348,652      |
| Weighted average diluted common shares outstanding            | 16,515,657     | 16,465,650      | 16,459,978     | 16,435,844      |



## **Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders

Heartland Financial USA, Inc.:

We have audited the accompanying consolidated balance sheets of Heartland Financial USA, Inc. and subsidiaries (the Company) as of December 31, 2011 and 2010, and the related consolidated statements of income, changes in stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2011. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Heartland Financial USA, Inc. and subsidiaries as of December 31, 2011 and 2010, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Heartland Financial USA, Inc.'s internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 15, 2012 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

**KPMG LLP**

Des Moines, Iowa

March 15, 2012



## **ITEM 9.**

### **CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

## **ITEM 9A.**

### **CONTROLS AND PROCEDURES**

#### **EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES**

Under the direction of our Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) promulgated under the Securities and Exchange Act of 1934, as amended) as of December 31, 2011. Based on that evaluation, our management, including the Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in applicable rules and forms and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, in a manner that allows timely decisions regarding required disclosure.

#### **MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control system was designed to provide reasonable assurance to our management, board of directors and stockholders regarding the reliability of financial reporting and the preparation and fair presentation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our internal control over financial reporting based upon the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control - Integrated Framework*. Based on our assessment, our internal control over financial reporting was effective as of December 31, 2011.

KPMG LLP, the independent registered public accounting firm that audited Heartland's consolidated financial statements as of and for the year ended December 31, 2011, included herein, has issued a report on Heartland's internal control over financial reporting. This report follows management's report.

#### **CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING**

During the second quarter of 2011, a new methodology, including the installation of new software, was implemented to assist in the management of interest rate risk in our mortgage loan origination operation. Management monitored these transition activities, including periodic reporting to the Audit Committee. No material internal control issues were encountered. There were no other significant changes to Heartland's disclosure controls or internal controls over financial reporting during 2011 that have materially affected or are reasonably likely to materially affect Heartland's internal control over financial reporting.



## Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Heartland Financial USA, Inc.:

We have audited Heartland Financial USA, Inc.'s internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Heartland Financial USA, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying *Management's Annual Report on Internal Control Over Financial Reporting*. Our responsibility is to express an opinion on Heartland Financial USA, Inc.'s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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

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

In our opinion, Heartland Financial USA, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Heartland Financial USA, Inc. and subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of income, changes in stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2011, and our report dated March 15, 2012 expressed an unqualified opinion on those consolidated financial statements.

KPMG LLP

Des Moines, Iowa

March 15, 2012

**ITEM 9B.**

**OTHER INFORMATION**

None

## **PART III**

### **ITEM 10.**

#### **DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information in the Proxy Statement for Heartland's 2012 Annual Meeting of Stockholders to be held on May 16, 2012 (the "2012 Proxy Statement") under the captions "Election of Directors", "Security Ownership of Certain Beneficial Owners and Management", "Section 16(a) Beneficial Ownership Reporting Compliance" and "Corporate Governance and the Board of Directors" is incorporated by reference. The information regarding executive officers is included in Part I of this report.

### **ITEM 11.**

#### **EXECUTIVE COMPENSATION**

The information in our 2012 Proxy Statement, under the captions "Compensation Discussion and Analysis", "Corporate Governance and the Board of Directors - Committees of the Board - Compensation/Nominating Committee", "Compensation/Nominating Committee Report On Executive Compensation" and "Executive Compensation" is incorporated by reference.

### **ITEM 12.**

#### **SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information in our 2012 Proxy Statement, under the caption "Security Ownership of Certain Beneficial Owners and Management" and "Equity Compensation Plan Discussion" is incorporated by reference.

### **ITEM 13.**

#### **CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information in the 2012 Proxy Statement under the captions "Transactions with Management" and "Corporate Governance and the Board of Directors - Our Board of Directors - Independence" is incorporated by reference.

### **ITEM 14.**

#### **PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information in the 2012 Proxy Statement under the caption "Relationship with Independent Registered Public Accounting Firm" is incorporated by reference.

## **PART IV**

### **ITEM 15.**

#### **EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

(a) The documents filed as a part of this report are listed below:

1. Financial Statements

The consolidated financial statements of Heartland Financial USA, Inc. are included in Item 8 of this Form 10-K.

2. Financial Statement Schedules

None

3. Exhibits

The exhibits required by Item 601 of Regulation S-K are included along with this Form 10-K and are listed on the "Index of Exhibits" immediately following the signature page.

## SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on March 14, 2012.

Heartland Financial USA, Inc.

|                               |  |
|-------------------------------|--|
| By: <u>/s/ Lynn B. Fuller</u> | <u>/s/ John K. Schmidt</u>   |
| Lynn B. Fuller                | John K. Schmidt  |
| Principal Executive Officer   | Executive Vice President<br>and Principal Financial and Accounting |

Date: March 14, 2012

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities indicated on March 14, 2012.

|  |   |
|--|---|
| By: <u>/s/ Lynn B. Fuller</u>            | <u>/s/ John K. Schmidt</u>                    |
| Lynn B. Fuller                           | John K. Schmidt                               |
| President, CEO, Chairman<br>and Director | Executive Vice President, CFO<br>and Director |
| <u>/s/ James F. Conlan</u>               | <u>/s/ Mark C. Falb</u>                       |
| James F. Conlan                          | Mark C. Falb                                  |
| Director                                 | Director                                      |
| <u>/s/ Thomas L. Flynn</u>               | <u>/s/ John W. Cox, Jr.</u>                   |
| Thomas L. Flynn                          | John W. Cox, Jr.                              |
| Director                                 | Director                                      |
| <u>/s/ James R. Hill</u>                 |   |
| James R. Hill                            |   |
| Director                                 |   |

## INDEX OF EXHIBITS

- 3.1 Certificate of Incorporation of Heartland Financial USA, Inc. (incorporated by reference to Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q filed on November 7, 2008).
- 3.2 Amendment to Certificate of Incorporation of Heartland Financial USA, Inc. (incorporated by reference to Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q filed on August 10, 2009).
- 3.3 Certificate of Designations of Fixed Rate Cumulative Perpetual Preferred Stock, Series B (incorporated by reference to Exhibit 3.1 to the Registrant's Current Report on Form 8-K filed on December 22, 2008).
- 3.4 Bylaws of Heartland Financial USA, Inc. (incorporated by reference to Exhibit 3.2 to the Registrant's Annual Report on Form 10-K filed on March 15, 2004).
- 3.5 Certificate of Designation of Senior Non-Cumulative Perpetual Preferred Stock, Series C, as filed with the Secretary of State of the State of Delaware on September 12, 2011 (incorporated by reference to Exhibit 3.1 to the Registrant's Form 8-K filed on September 15, 2011).
- 4.1 Form of Specimen Stock Certificate for Heartland Financial USA, Inc. common stock (incorporated by reference to Exhibit 4.1 to Registrant's Registration Statement on Form S-4 (File No. 33-76228) filed on May 4, 1994).
- 4.2 Rights Agreement, dated as of June 7, 2002, between Heartland Financial USA, Inc. and Dubuque Bank and Trust Company, as Rights Agent (incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K filed on June 11, 2002).
- 4.3 Form of Indenture between Heartland Financial USA, Inc. and U.S. Bank National Association, as Trustee, to be used in connection with the issuance of senior debt securities (incorporated by reference to Exhibit 4.3 to the Registrant's Registration Statement on Form S-3 filed on May 15, 2009).
- 4.4 Form of Indenture between Heartland Financial USA, Inc. and U.S. Bank National Association, as Trustee, to be used in connection with the issuance of subordinated debt securities (incorporated by reference to Exhibit 4.4 to the Registrant's Registration Statement on Form S-3 filed on May 15, 2009).
- 4.5 Form of Stock Certificate for Fixed Senior Non-Cumulative Perpetual Preferred Stock, Series C (incorporated by reference to Exhibit 4.1 to the Registrant's Form 8-K filed on September 15, 2011).
- 10.1 Heartland Financial USA, Inc. Dividend Reinvestment Plan dated as of January 24, 2002 (incorporated by reference to the Registrant's Registration Statement on Form S-3 filed on January 25, 2002).
- 10.2 <sup>(1)</sup> Heartland Financial USA, Inc. 2003 Stock Option Plan dated as of May 21, 2003 (incorporated by reference to Exhibit B to the Registrant's Proxy Statement on Form DEF14A filed on April 7, 2003).
- 10.3 Indenture by and between Heartland Financial USA, Inc. and U.S. Bank National Association, dated as of October 10, 2003 (incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q filed on November 13, 2003).
- 10.4 Indenture by and between Heartland Financial USA, Inc. and U.S. Bank National Association dated as of March 17, 2004 (incorporated by reference to Exhibit 10.12 to the Registrant's Annual Report on Form 10-K filed on March 14, 2007).

- 10.5 Indenture by and between Heartland Financial USA, Inc. and Wells Fargo Bank, National Association, dated as of January 31, 2006 (incorporated by reference to Exhibit 10.19 to the Registrant's Annual Report on Form 10-K filed on March 10, 2006).
- 10.6 <sup>(1)</sup> Heartland Financial USA, Inc. 2005 Long-Term Incentive Plan (incorporated by reference to Exhibit 10.01 to the Registrant's Current Report on Form 8-K filed on May 19, 2005).
- 10.7 Heartland Financial USA, Inc. 2006 Employee Stock Purchase Plan effective January 1, 2006 (incorporated by reference to Exhibit 10.02 to the Registrant's Current Report on Form 8-K filed on May 19, 2005).
- 10.8 <sup>(1)</sup> Form of Agreement for Heartland Financial USA, Inc. 2005 Long-Term Incentive Plan Non-Qualified Stock Option Awards (incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed on February 10, 2006).
- 10.9 <sup>(1)</sup> Form of Agreement for Heartland Financial USA, Inc. 2005 Long-Term Incentive Plan Performance Restricted Stock Agreement (incorporated by reference to Exhibit 10.21 to the Registrant's Annual Report on Form 10-K filed on March 10, 2006).
- 10.10 Indenture between Heartland Financial USA, Inc. and Wilmington Trust Company dated as of June 26, 2007 (incorporated by reference to Exhibit 10.3 to the Registrant's Quarterly Report on Form 10-Q filed on August 9, 2007).
- 10.11 Indenture between Heartland Financial USA, Inc. and Wilmington Trust Company dated as of June 26, 2007 (incorporated by reference to Exhibit 10.3 to the Registrant's Quarterly Report on Form 10-Q filed on August 9, 2007).
- 10.12 <sup>(1)</sup> Change of Control Agreements between Heartland Financial USA, Inc. and Executive Officers dated September 7, 2007 (incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed on September 7, 2007).
- 10.13 Subscription and Shareholder Agreement between Heartland Financial USA, Inc. and Investors in Minnesota Bank & Trust dated as of September 21, 2007 (incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q filed on November 9, 2007).
- 10.14 <sup>(1)</sup> Heartland Financial USA, Inc. Policy on Director Fees and Policy on Expense Reimbursement For Directors (incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K filed on December 5, 2007).
- 10.15 <sup>(1)</sup> Form of Split-Dollar Life Insurance Plan effective November 13, 2001, between the subsidiaries of Heartland Financial USA, Inc. and their selected officers, including four subsequent amendments effective January 1, 2002, May 1, 2002, September 16, 2003 and December 31, 2007. These plans are in place at Dubuque Bank and Trust Company, Galena State Bank & Trust Co., Riverside Community Bank, Wisconsin Community Bank and New Mexico Bank & Trust (incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q filed on May 12, 2008).
- 10.16 <sup>(1)</sup> Form of Executive Supplemental Life Insurance Plan effective January 1, 2005, between the subsidiaries of Heartland Financial USA, Inc. and their selected officers, including a subsequent amendment effective December 31, 2007. These plans are in place at Dubuque Bank and Trust Company, Galena State Bank & Trust Co., Riverside Community Bank, Wisconsin Community Bank and New Mexico Bank & Trust (incorporated by reference to Exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q filed on May 12, 2008).
- 10.17 <sup>(1)</sup> Form of Executive Life Insurance Bonus Plan effective December 31, 2007, between Heartland Financial USA, Inc. and selected officers of Heartland Financial USA, Inc. and its subsidiaries, including a subsequent amendment effective December 31, 2007 (incorporated by reference to Exhibit 10.18 to the Registrant's Annual Report on Form 10-K filed on March 16, 2009).



- 10.18 <sup>(1)</sup> Form of Split-Dollar Agreement effective November 1, 2008, between the subsidiaries of Heartland Financial USA, Inc. and their selected officers. These plans are in place at Dubuque Bank and Trust Company, Galena State Bank & Trust Co., Riverside Community Bank, Wisconsin Community Bank, New Mexico Bank & Trust, Arizona Bank & Trust, Summit Bank & Trust, Minnesota Bank & Trust and Citizens Finance Co. (incorporated by reference to Exhibit 10.19 to the Registrant's Annual Report on Form 10-K filed on March 16, 2009).
- 10.19 <sup>(1)</sup> Form of Agreement for Heartland Financial USA, Inc. 2005 Long-Term Incentive Plan Performance Restricted Stock Unit Agreement with those individuals subject to settlement restrictions due to Heartland's participation in the United States Treasury's Troubled Asset Relief Program.(incorporated by reference to Exhibit 10.23 to the Registrant's Annual Report on Form 10-K filed on March 16, 2010).
- 10.20 <sup>(1)</sup> Form of Agreement for Heartland Financial USA, Inc. 2005 Long-Term Incentive Plan Performance Restricted Stock Unit Agreement with those individuals not subject to settlement restrictions due to Heartland's participation in the United States Treasury's Troubled Asset Relief Program (incorporated by reference to Exhibit 10.24 to the Registrant's Annual Report on Form 10-K filed on March 16, 2010).
- 10.21 Form of Senior Notes of Heartland Financial USA, Inc. (incorporated by reference to Exhibit 10.26 to the Registrant's Annual Report on Form 10-K filed on March 16, 2011).
- 10.22 Promissory Note between Heartland Financial USA, Inc. and Valley Bank dated as of November 12, 2010 (incorporated by reference to the Registrant's Annual Report on Form 10-K filed on March 16, 2011).
- 10.23 Promissory Note between Heartland Financial USA, Inc. and Bankers Trust Company dated as of April 20, 2011, including Loan Commitment Letter dated April 5, 2011 (incorporated by reference to Exhibit 10.1 to the Registrant's Quarterly Report on Form 10-Q filed on May 10, 2011).
- 10.24 ISDA Confirmation Letter between Heartland Financial USA, Inc. and Bankers Trust Company dated April 5, 2011 (incorporated by reference to Exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q filed on May 10, 2011).
- 10.25 Promissory Note between Heartland Financial USA, Inc. and Bankers Trust Company dated April 20, 2011 (incorporated by reference to Exhibit 10.3 to the Registrant's Quarterly Report on Form 10-Q filed on May 10, 2011).
- 10.26 Securities Purchase Agreement between Heartland Financial USA, Inc. and the Secretary of the Treasury dated September 15, 2011 (incorporated by reference to Exhibit 10.1 to the Registrant's Form 8-K filed on September 15, 2011).
- 10.27 Repurchase Document between Heartland Financial USA, Inc. and the United States Department of the Treasury dated September 15, 2011 (incorporated by reference to Exhibit 10.2 to the Registrant's Form 8-K filed on September 15, 2011).
- 10.28 Warrant Letter Agreement between Heartland Financial USA, Inc. and the United States Department of the Treasury dated September 28, 2011 (incorporated by reference to Exhibit 10.1 to the Registrant's Form 8-K filed on September 28, 2011).
- 11 <sup>(2)</sup> [Statement re Computation of Per Share Earnings.](#)
- 21.1 <sup>(2)</sup> [Subsidiaries of the Registrant.](#)
- 23.1 <sup>(2)</sup> [Consent of KPMG LLP.](#)
- 31.1 <sup>(2)</sup> [Certification of Chief Executive Officer pursuant to Rule 13a-15.](#)

- 31.2 <sup>(2)</sup> Certification of Chief Financial Officer pursuant to Rule 13a-15.
- 32.1 <sup>(2)</sup> Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 <sup>(2)</sup> Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.1 <sup>(2)</sup> Certification of Chief Executive Officer pursuant to Section 111(b)(4) of the Emergency Economic Stabilization Act of 2008.
- 99.2 <sup>(2)</sup> Certification of Chief Financial Officer pursuant to Section 111(b)(4) of the Emergency Economic Stabilization Act of 2008.
- 101 <sup>(2)</sup> Financial statement formatted in Extensible Business Reporting Language: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Cash Flows, (iv) the Consolidated Statements of Changes in Equity and Comprehensive Income, and (v) the Notes to Consolidated Financial Statements.

(1) Management contracts or compensatory plans or arrangements.

(2) Filed herewith.

OUR MISSION

Through excellence in customer service and respect for the individual, everyone profits.

The company commits itself to:

|   |   |   |
|---|---|---|
| Exceeding customers' expectations by delivering a full range of quality financial products and services through a highly personal and professional sales staff. | Differentiating ourselves as a growing consortium of strong community banks through community involvement, active boards of directors, local presidents and local decision making at point of sale and service. | Integrating customer-transparent support functions to gain economies of scale and remain price competitive.                                   |
| Expanding economic activity in the markets we serve, consistent with prudent business judgment and being a good corporate citizen.                              | Providing satisfying employment in a positive work culture with compensation packages that compare favorably with other high-performance banks in our regions.  | Managing member bank resources strategically toward the achievement of high performance within the industry and increasing shareholder value. |



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