HEARTLAND FINANCIAL USA INC
Form 10-Q
August 09, 2006

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

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

For quarterly period ended June 30, 2006
TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934
For transition period __________ to __________

Commission File Number: 0-24724

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

Delaware
(State or other jurisdiction of incorporation or organization)

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

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

(563) 589-2100
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act.
Large accelerated filer **Accelerated filer x** **Non-accelerated filer**

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

Indicate the number of shares outstanding of each of the classes of Registrant's common stock as of the latest practicable date: As of August 8, 2006, the Registrant had outstanding 16,517,634 shares of common stock, $1.00 par value per share.

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

Part I

Part II

PART I

ITEM 1. FINANCIAL STATEMENTS

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

	June 30, 2006 (Unaudited)	December 31, 2005
ASSETS		
Cash and due from banks	$ 36,945	$ 40,422
Federal funds sold and other short-term investments	10,440	40,599
Cash and cash equivalents	47,385	81,021
Securities:		
Trading, at fair value	788	515
Available for sale, at fair value (cost of $533,460 at June 30, 2006, and $528,647 at December 31, 2005)	525,996	527,252
Loans held for sale	44,686	40,745
Gross loans and leases:		
Loans and leases	2,077,393	1,953,066
Allowance for loan and lease losses	(29,941)	(27,791)
Loans and leases, net	2,047,452	1,925,275
Assets under operating leases	39,852	40,644
Premises, furniture and equipment, net	105,146	92,769
Other real estate, net	1,693	1,586
Goodwill	40,531	35,398
Intangible assets, net	9,327	9,159
Bank owned life insurance	33,386	32,804
Other assets	39,069	31,164
TOTAL ASSETS	$ 2,935,311	$ 2,818,332
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES:		
Deposits:		
Demand	$ 378,211	$ 352,707
Savings	799,884	754,360
Time	1,075,134	1,011,111
Total deposits	2,253,229	2,118,178
Short-term borrowings	229,723	255,623
Other borrowings	225,650	220,871
Accrued expenses and other liabilities	35,251	35,848
TOTAL LIABILITIES	2,743,853	2,630,520
STOCKHOLDERS' EQUITY:		
Preferred stock (par value $1 per share; authorized, 184,000 shares; none issued or outstanding)	-	-
Series A Junior Participating preferred stock (par value $1 per share; authorized, 16,000	-	-

shares; none issued or outstanding)				
Common stock (par value $1 per share; authorized, 20,000,000 shares; issued 16,556,745 shares at June 30, 2006, and 16,547,482 shares at December 31, 2005)		16,557		16,547
Capital surplus		37,877		40,256
Retained earnings		142,852		135,112
Accumulated other comprehensive loss		(4,958)		(1,011)
Treasury stock at cost (35,925 shares at June 30, 2006, and 157,067 shares at December 31, 2005)		(870)		(3,092)
TOTAL STOCKHOLDERS’ EQUITY		191,458		187,812
TOTAL LIABILITIES AND STOCKHOLDERS’ EQUITY	$	2,935,311	$	2,818,332

See accompanying notes to consolidated financial statements.

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

	Three Months Ended		Six Months Ended	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
INTEREST INCOME:				
Interest and fees on loans and leases	$ 41,411	$ 32,596	$ 79,329	$ 62,584
Interest on securities:				
Taxable	3,991	3,567	7,874	7,098
Nontaxable	1,469	1,333	2,897	2,658
Interest on federal funds sold and other short-term investments	127	57	301	104
Interest on interest bearing deposits in other financial institutions	7	79	12	147
TOTAL INTEREST INCOME	47,005	37,632	90,413	72,591
INTEREST EXPENSE:				
Interest on deposits	14,852	10,282	27,939	19,464
Interest on short-term borrowings	2,932	1,709	5,383	2,973
Interest on other borrowings	3,151	2,540	6,195	5,046
TOTAL INTEREST EXPENSE	20,935	14,531	39,517	27,483
NET INTEREST INCOME	26,070	23,101	50,896	45,108
Provision for loan and lease losses	1,485	1,636	2,657	3,000
NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES	24,585	21,465	48,239	42,108
NONINTEREST INCOME:				
Service charges and fees	2,738	2,307	5,339	4,547
Loan servicing income	1,058	726	2,038	1,384
Trust fees	1,741	1,605	3,558	3,200
Brokerage commissions	369	255	612	478
Insurance commissions	141	129	277	266
Securities gains(losses), net	229	(20)	361	33
Gain(loss) on trading account securities, net	(25)	(26)	8	(8)
Rental income on operating leases	4,007	3,845	8,068	7,416
Gain on sale of loans	577	644	1,127	1,176
Valuation adjustment on mortgage servicing rights	-	(34)	-	(18)
Income on bank owned life insurance	235	243	528	506
Other noninterest income	244	366	583	775
TOTAL NONINTEREST INCOME	11,314	10,040	22,499	19,755
NONINTEREST EXPENSE:				
Salaries and employee benefits	13,043	11,529	26,127	22,711
Occupancy	1,820	1,534	3,613	3,160
Furniture and equipment	1,719	1,542	3,410	2,909
Depreciation on equipment under operating leases	3,202	3,141	6,457	6,069
Outside services	2,599	1,957	4,755	3,955
Advertising	1,027	767	2,151	1,576
Intangible assets amortization	238	237	466	507

Other noninterest expense	3,101	2,752	8,326	5,323
TOTAL NONINTEREST EXPENSE	26,749	23,459	55,305	46,210
INCOME BEFORE INCOME TAXES	9,150	8,046	15,433	15,653
Income taxes	2,928	2,640	4,738	4,983
NET INCOME	$ 6,222	$ 5,406	$ 10,695	$ 10,670
EARNINGS PER COMMON SHARE - BASIC	$ 0.38	$ 0.33	$ 0.65	$ 0.65
EARNINGS PER COMMON SHARE - DILUTED	$ 0.37	$ 0.32	$ 0.64	$ 0.64
CASH DIVIDENDS DECLARED PER COMMON SHARE	$ 0.09	$ 0.08	$ 0.18	$ 0.16

See accompanying notes to consolidated financial statements.

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

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total
Balance at January 1, 2005	$ 16,547	$ 40,446	$ 117,800	$ 2,889	$ (1,900)	$ 175,782
Net income			10,670			10,670
Unrealized loss on securities available for sale arising during the period				(973)		(973)
Reclassification adjustment for net security gains realized in net income				(33)		(33)
Unrealized gain on derivatives arising during the period, net of realized losses of $169				341		341
Income taxes				227		227
Comprehensive income						10,232
Cash dividends declared:						
Common, $0.16 per share			(2,629)			(2,629)
Purchase of 203,919 shares of common stock					(4,071)	(4,071)
Issuance of 162,332 shares of common stock		(359)			3,049	2,690
Commitments to issue common stock		242				242
Balance at June 30, 2005	$ 16,547	$ 40,329	$ 125,841	$ 2,451	$ (2,922)	$ 182,246
Balance at January 1, 2006	$ 16,547	$ 40,256	$ 135,112	$ (1,011)	$ (3,092)	$ 187,812
Net income			10,695			10,695
Unrealized loss on securities available for sale arising during the period				(5,708)		(5,708)

Reclassification adjustment for net security gains realized in net income				(361)		(361)
Unrealized loss on derivatives arising during the period, net of realized losses of $41				(259)		(259)
Income taxes				2,381		2,381
Comprehensive income						6,748
Cash dividends declared:						
Common, $0.18 per share			(2,955)			(2,955)
Purchase of 100,479 shares of common stock					(2,267)	(2,267)
Issuance of 230,884 shares of common stock	10	(2,774)			4,489	1,725
Commitments to issue common stock		395				395
Balance at June 30, 2006	$ 16,557	$ 37,877	$ 142,852	$ (4,958)	$ (870)	$ 191,458

See accompanying notes to consolidated financial statements.

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

	Six Months Ended	
	June 30, 2006	June 30, 2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 10,695	$ 10,670
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Depreciation and amortization	10,493	9,652
Provision for loan and lease losses	2,657	3,000
Net amortization of premium on securities	588	1,524
Securities gains, net	(361)	(33)
(Increase) decrease in trading account securities	(273)	33
Stock-based compensation	395	242
Loans originated for sale	(136,681)	(126,426)
Proceeds on sales of loans	133,867	109,838
Net gain on sales of loans	(1,127)	(1,176)
Increase in accrued interest receivable	(1,870)	(1,284)
Increase in accrued interest payable	1,184	534
Other, net	(6,446)	(11,222)
NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES	13,121	(4,648)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Proceeds from the maturity of time deposits	-	1,178
Proceeds from the sale of securities available for sale	8,826	18,100
Proceeds from the maturity of and principal paydowns on securities available for sale	42,830	76,822
Purchase of securities available for sale	(48,426)	(52,104)
Net increase in loans and leases	(74,971)	(83,462)
Increase in assets under operating leases	(5,665)	(11,926)
Capital expenditures	(15,289)	(11,976)
Net cash and cash equivalents paid in acquisition of subsidiaries, net of cash received	(15,015)	-
Proceeds on sale of OREO and other repossessed assets	1,510	564
NET CASH USED BY INVESTING ACTIVITIES	(106,200)	(62,804)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in demand deposits and savings accounts	36,629	20,611
Net increase in time deposit accounts	53,969	47,956
Net increase (decrease) in short-term borrowings	(31,207)	57
Proceeds from other borrowings	21,693	36,006

Repayments of other borrowings		(16,914)		(20,545)
Purchase of treasury stock		(2,267)		(4,071)
Proceeds from issuance of common stock		382		1,329
Excess tax benefits on exercised stock options		113		-
Dividends paid		(2,955)		(2,629)
NET CASH PROVIDED BY FINANCING ACTIVITIES		59,443		78,714
Net increase (decrease) in cash and cash equivalents		(33,636)		11,262
Cash and cash equivalents at beginning of year		81,021		73,749
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$	47,385	$	85,011
Supplemental disclosures:				
Cash paid for income/franchise taxes	$	5,587	$	5,660
Cash paid for interest	$	38,304	$	26,949
Acquisitions:				
Net assets acquired	$	13,061	$	-
Cash paid for purchase of stock	$	18,081	$	-
Cash acquired	$	3,066	$	-
Net cash paid for acquisitions	$	(15,015)	$	-

See accompanying notes to consolidated financial statements.

HEARTLAND FINANCIAL USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1: BASIS OF PRESENTATION

The interim unaudited consolidated financial statements contained herein should be read in conjunction with the audited consolidated financial statements and accompanying notes to the consolidated financial statements for the fiscal year ended December 31, 2005, included in Heartland Financial USA, Inc.'s ("Heartland") Form 10-K filed with the Securities and Exchange Commission on March 10, 2006. Accordingly, footnote disclosures, which would substantially duplicate the disclosure contained in the audited consolidated financial statements, have been omitted.

The financial information of Heartland included herein have been prepared in accordance with U.S. generally accepted accounting principles for interim financial reporting and have been prepared pursuant to the rules and regulations for reporting on Form 10-Q and Rule 10-01 of Regulation S-X. Such information reflects all adjustments (consisting of normal recurring adjustments), that are, in the opinion of management, necessary for a fair presentation of the financial position and results of operations for the periods presented. The results of the interim periods ended June 30, 2006, are not necessarily indicative of the results expected for the year ending December 31, 2006.

Earnings Per Share

Basic earnings per share is determined using net income and weighted average common shares outstanding. Diluted earnings per share is computed by dividing net income by the weighted average common shares and assumed incremental common shares issued. Amounts used in the determination of basic and diluted earnings per share for the three-month and six-month periods ended June 30, 2006 and 2005, are shown in the tables below:

	Three Months Ended	
(Dollars in thousands)	6/30/06	6/30/05
Net income	$ 6,222	$ 5,406
Weighted average common shares outstanding for basic earnings per share (000's)	16,541	16,420
Assumed incremental common shares issued upon exercise of stock options (000's)	258	302
Weighted average common shares for diluted earnings per share (000's)	16,799	16,722
Earnings per common share - basic	$ 0.38	$ 0.33
Earnings per common share - diluted	$ 0.37	$ 0.32

	Six Months Ended	
(Dollars in thousands)	6/30/06	6/30/05
Net income	$ 10,695	$ 10,670
Weighted average common shares outstanding for basic earnings per share (000's)	16,486	16,450
Assumed incremental common shares issued upon exercise of stock options (000's)	242	304
Weighted average common shares for diluted earnings per share (000's)	16,728	16,754
Earnings per common share - basic	$ 0.65	$ 0.65
Earnings per common share - diluted	$ 0.64	$ 0.64

Stock-Based Compensation

Effective January 1, 2006, Heartland adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004) ("FAS 123R"), *Share-Based Payment* using the "modified prospective" transition method. FAS 123R 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. Under the "modified prospective" transition method, awards that are granted, modified or settled beginning at the date of adoption are measured and accounted for in accordance with FAS 123R. In addition, expense must be recognized in the income statement for unvested awards that were granted prior to the date of adoption. The expense is based on the fair value determined at the grant date. The impact of the adoption of FAS 123R on Heartland's consolidated financial statements for the year ending on December 31, 2006, is expected to be a reduction in net income of $290 thousand or diluted earnings per share of $0.02.

Heartland's 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. 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. Under the terms of the 2005 Long-Term Incentive Plan, 1,000,000 shares have been reserved for issuance. A summary of the principal features is provided in Heartland's 2005 Proxy Statement.

On May 18, 2005, stock awards totaling 136,500 shares were granted to key policy-making employees. These awards were granted at no cost to the employee. These awards are contingent upon the achievement of performance objectives through December 31, 2009, and completely vest on December 31, 2011. Compensation expense is being recognized ratably over the vesting period.

Options have been granted with an exercise price equal to the fair market value of Heartland 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. The 2005 Long-Term Incentive Plan was adopted on May 18, 2005, which replaced the 2003 Stock Option Plan. The 2003 Stock Option Plan had previously replaced the 1993 Stock Option Plan.

Information concerning the issuance of stock options is presented in the following table:

	Shares	**Weighted- Average Exercise Price**	
Outstanding at January 1, 2006	796,650	$	12.70
Granted	130,750		21.60
Exercised	(22,200)		8.27
Forfeited	(7,400)		16.04
Outstanding at June 30, 2006	897,800	$	14.08
Weighted-average fair value of options granted during the six-month period ended June 30, 2006	$5.65		

At June 30, 2006, the vested options totaled 483,175 shares with a weighted average exercise price of $10.17 per share and a weighted average remaining contractual life of 2.90 years. The intrinsic value for the vested options as of June 30, 2006, was $8.0 million. The intrinsic value for the total of all options exercised during the six months ended June 30, 2006, was $408 thousand, and the total fair value of shares vested during the six months ended June 30, 2006, was $237 thousand.

At June 30, 2006, shares available for issuance under the 2005 Long-Term Incentive Plan totaled 743,360.

The fair value of the 2006 stock options granted was estimated utilizing the Black Scholes valuation model. The grant date fair value for the 2006 options was $21.60. Significant assumptions include:

	2006
Risk-free interest rate	4.52%
Expected option life	7 years
Expected volatility	22.00%
Expected dividends	2.00%

The option term of each award granted was based upon Heartland's historical experience of employees' exercise behavior. Expected volatility was based upon historical volatility levels and future expected volatility of Heartland's common stock. Expected dividend yield was based on a set dividend rate. Risk free interest rate reflects the yield on the 7 year zero coupon U.S. Treasury bond. Cash received from options exercised for the six months ended June 30, 2006, was $183 thousand, with a related tax benefit of $113 thousand.

Total compensation costs recorded were $395 thousand for the six months ended June 30, 2006, and $242 thousand for the six months ended June 30, 2005, for stock options and the restricted stock awards. As of June 30, 2006, there was $3.6 million of total unrecognized compensation costs related to the 2005 Long-Term Incentive Plan for stock options and restricted stock awards which is expected to be recognized through 2011.

Prior to adopting FAS 123R, Heartland applied APB Opinion 25 in accounting for its Stock Option Plan and, accordingly, no compensation cost for its stock options was recognized in the financial statements. Pursuant to the disclosure requirements of FAS 123R, pro forma net income and earnings per share for the three-month and six-month periods ended June 30, 2005, are presented in the following table as if compensation cost for stock options was determined under the fair value method and recognized as expense over the options' vesting periods:

	Three Months Ended 6/30/05	**Six Months Ended 6/30/05**
(Dollars in thousands, except per share data)		
Net income as reported	$ 5,406	10,670
Pro forma	5,406	10,460
Earnings per share-basic as reported	$ 0.33	0.65
Pro forma	0.33	0.64
Earnings per share-diluted as reported	$ 0.32	0.64
Pro forma	0.32	0.62

New Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* ("FAS 154"), replacing APB Opinion No. 20, *Accounting for Changes*, and FAS 3, *Reporting Accounting Changes in Interim Financial Statements*. Unless specified in an accounting standard, FAS 154 requires retrospective application to prior periods' financial statements for changes in accounting principle and correction of errors. APB Opinion No. 20 previously provided that most changes in accounting principle be recognized by including in net income the cumulative effect of changing to the new principle in the period of adoption. FAS 154 is effective for fiscal years beginning after December 15, 2005. Heartland's adoption of FAS 154 on January 1, 2006, did not have a material effect on the consolidated financial statements.

In February 2006, the FASB issued Statement of Financial Accounting Standards No. 155, *Accounting for Certain Hybrid Financial Instruments* ("FAS 155"), an amendment to Statement of Financial Accounting Standards No. 133 and

140. FAS 155 provides the framework for fair value remeasurement of any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. It also clarifies which interest-only strips and principal-only strips are not subject to the requirements of FAS 133 and establishes a requirement to evaluate interests in securitized financial assets to identify interests that contain an embedded derivative requiring bifurcation. FAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including financial statements for any interim period for that fiscal year. Heartland has not early-adopted the provisions of FAS 155 and does not currently anticipate that the impact of such adoption on January 1, 2007, will have a material impact on its consolidated financial statements.

In March 2006, the FASB issued Statement of Financial Accounting Standards No. 156 ("FAS 156"), *Accounting for Servicing of Financial Assets*, an amendment of FASB Statement No. 140 ("FAS 140"), *Accounting for Transfers and Extinguishments of Liabilities*. FAS 156 requires that all separately recognized servicing assets and servicing liabilities be initially measured at fair value, if practicable, and permits the entity to elect either the fair value measurement method with changes in fair value reflected in earnings or the amortization method as defined in FAS 140 for subsequent measurements. The subsequent measurement of separately recognized servicing assets and servicing liabilities at fair value eliminates the necessity for entities that manage the risks inherent in servicing assets and servicing liabilities with derivatives to qualify for hedge accounting treatment and eliminates the characterization of declines in fair value as impairments or direct write-downs. FAS 156 is effective as of the beginning of an entity's first fiscal year that begins after September 15, 2006. Earlier adoption is permitted as of the beginning of an entity's fiscal year, provided the entity has not yet issued financial statements, including interim financial statements for any period of that fiscal year. Heartland plans to adopt FAS 156 on January 1, 2007, and is in the process of assessing the impact of the adoption of this statement on its consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* ("FIN 48"), which is an interpretation of FASB Statement No. 109, *Accounting for Income Taxes*. This interpretation prescribes the minimum recognition threshold a tax position must meet before being recognized in the financial statements. FIN 48 also provides guidance on the derecognition, measurement, classification, interest and penalties, accounting in interim periods and disclosure requirements for uncertain tax positions. FIN 48 is effective as of the beginning of an entity's first fiscal year that begins after December 15, 2006. Differences between the amounts recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption should be accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings. The cumulative effect adjustment would not apply to those items that would not have been recognized in earnings, such as the effect of adopting FIN 48 on tax positions related to business combinations. Heartland plans to adopt FIN 48 on January 1, 2007, and is in the process of assessing the impact of the adoption of this statement on its consolidated financial statements.

NOTE 2: CORE DEPOSIT PREMIUM AND OTHER INTANGIBLE ASSETS

The gross carrying amount of intangible assets and the associated accumulated amortization at June 30, 2006, and December 31, 2005, are presented in the table below, in thousands:

	June 30, 2006		December 31, 2005	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Intangible assets:				
Core deposit intangibles	$ 9,756	$ 4,602	$ 9,217	$ 4,163
Mortgage servicing rights	5,060	1,702	4,685	1,422
Customer relationship intangible	917	102	917	75

Total	$	15,733	$	6,406	$	14,819	$	5,660
Intangible assets, net			$	9,327			$	9,159

Projections of amortization expense for mortgage servicing rights are based on existing asset balances and the existing interest rate environment as of June 30, 2006. What Heartland actually experiences may be significantly different depending upon changes in mortgage interest rates and market conditions. There was no valuation allowance on mortgage servicing rights at June 30, 2006, and at December 31, 2005.

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

	Core Deposit Intangibles		Mortgage Servicing Rights		Customer Relationship Intangible		Total	
Six months ending December 31, 2006	$	493	$	480	$	27	$	1,000
Year ending December 31,								
2007		905		823		53		1,781
2008		886		685		52		1,623
2009		787		548		50		1,385
2010		505		411		49		965
2011		489		274		47		810
Thereafter		1,089		137		537		1,763

NOTE 3: DERIVATIVE FINANCIAL INSTRUMENTS

On occasion, Heartland uses derivative financial instruments as part of its interest rate risk management, including interest rate swaps, caps, floors and collars. On April 4, 2006, Heartland entered into a three-year interest rate collar transaction on a notional amount of $50.0 million to further reduce the potentially negative impact a downward movement in interest rates would have on its net interest income. The collar has an effective date of April 4, 2006, and a maturity date of April 4, 2009. This collar transaction is designated as a cash flow hedge of the overall changes in the cash flows above and below the collar strike rates associated with interest payments on certain Heartland prime-based loans that reset with changes in the prime rate. Heartland is the payer on prime at a cap strike rate of 8.95% and the counterparty is the payer on prime at a floor strike rate of 7.00%. As of June 30, 2006, the fair market value of this collar transaction was recorded as a liability of $107 thousand and was accounted for as a cash flow hedge.

On September 19, 2005, Heartland entered into a five-year interest rate collar transaction on a notional amount of $50.0 million to further reduce the potentially negative impact a downward movement in interest rates would have on its net interest income. The collar has an effective date of September 21, 2005, and a maturity date of September 21, 2010. This collar transaction is designated as a cash flow hedge of the overall changes in the cash flows above and below the collar strike rates associated with interest payments on certain Heartland prime-based loans that reset with changes in the prime rate. Heartland is the payer on prime at a cap strike rate of 9.00% and the counterparty is the payer on prime at a floor strike rate of 6.00%. As of June 30, 2006, the fair market value of this collar transaction was recorded as a liability of $338 thousand and was accounted for as a cash flow hedge.

Heartland also has an interest rate swap contract to effectively convert $25.0 million of its variable interest rate debt to fixed interest rate debt. As of June 30, 2006, Heartland had an interest rate swap contract with a notional amount of $25.0 million to pay a fixed interest rate of 4.35% and receive a variable interest rate of 4.61% based on $25.0 million of indebtedness. Payments under the interest rate swap contract are made monthly. This contract expires on November

1, 2006. The fair market value of the interest rate swap contract was recorded as an asset of $99 thousand as of June 30, 2006, and is accounted for as a cash flow hedge.

There was no ineffectiveness recognized on these cash flow hedge transactions for the quarter and six months ended June 30, 2006. All components of the derivative instruments' gain or loss were included in the assessment of hedge effectiveness.

On July 8, 2005, Heartland entered into a two-year interest rate floor transaction on prime at a strike level of 5.5% on a notional amount of $100.0 million. All changes in the fair market value of this hedge transaction of $1 thousand flowed through Heartland's income statement under the other noninterest income category during the first six months of 2006 since it is accounted for as a free-standing derivative. As of June 30, 2006, this floor contract had a fair market value of $0.

By using derivatives, Heartland is exposed to credit risk if counterparties to derivative instruments do not perform as expected. Heartland minimizes this risk by entering into derivative contracts with large, stable financial institutions and Heartland has not experienced any losses from counterparty nonperformance on derivative instruments.

NOTE 4: ACQUISITIONS

On May 15, 2006, Heartland's acquisition of Bank of the Southwest was completed. Immediately upon completion, the acquired entity became a part of Arizona Bank & Trust, Heartland's *de novo* bank chartered in 2003. As of the acquisition date, total assets at Bank of the Southwest were $63.2 million, total loans were $52.4 million and total deposits were $44.4 million. The purchase price was $18.1 million, all in cash. The resultant acquired core deposit intangible of $539 thousand is being amortized over a period of eight years. The remaining excess purchase price over the fair value of tangible and identifiable intangible assets acquired of $5.1 million was recorded as goodwill.

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