UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

(Mark One)

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

For the fiscal year ended December 31, 2005

OR

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

For the transition period from _________ to _________

Commission file number: 000-51761

Digital Music Group, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**20-3365526**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

1545 River Park Drive, Suite 210

Sacramento, CA 95815

(Address of principal executive offices, including ZIP Code)

(916) 239-6010

(Registrant s telephone number, including area code)

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

None

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

Common Stock, $0.01 par value

(Title of class)

Indicate by check if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Act: Yes ¨ No x

Indicate by check if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act: Yes ¨ No x

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 x

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. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer:

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act): Yes ¨ No x

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2005: not applicable because trading of the registrant s Common Stock on the Nasdaq National Market did not commence until February 2, 2006.

As of March 27, 2006, the registrant had 8,614,941 shares of Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s Proxy Statement for the 2006 Annual Meeting of Stockholders are incorporated by reference into Part II and Part III of this Annual Report on Form 10-K to the extent stated herein. The Proxy Statement will be filed within 120 days of the registrant s fiscal year ended December 31, 2005.

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PART I

Forward-Looking Statements

This Annual Report on Form 10-K contains forward-looking statements within the meaning of the federal securities laws. These statements relate to future events or our future financial performance and involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from those expressed or implied by the forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may , likely , will , should , expe plan , anticipate , believe , estimate , predict , potential , continue or the negative of these terms or other comparable terminology. These forward-looking statements include, but are not limited to, the statements relating to: our financial condition; results of operations;, download activity; business strategy; future operating performance; industry growth trends; contracts with online music stores; management focus and objectives; business prospects; the purchase and license of music recordings by us; the processing of music recordings by us; the delivery of music recordings to the online music stores; the access we provide to content owners to online music stores; the access to new music recordings we provide to consumers at online music stores; the new outlets we seek for our digital rights; the expansion of our equipment, software and other infrastructure; the compilations we create; the digital rights acquisition terms we seek from content owners; the possible acquisition of companies by us; the potential use of our equity in acquisitions; the amount of due diligence we perform in connection with acquisitions; the decrease as a percentage that we expect in our short-term distribution revenue; and that our cash and office facilities will be appropriate for our next twelve months of operations. You should not place undue reliance on these forward-looking statements, which are based on our current views and assumptions. In evaluating these statements, you should specifically consider various factors, including the risks outlined under Risk Factors. Many of these factors are beyond our control. Our forward-looking statements represent estimates and assumptions only as of the date of this Annual Report on Form 10-K. Except as required by law, we undertake no obligation to update any forward-looking statement to reflect events or circumstances occurring after the date of this Annual Report on Form 10-K.

Item 1. BUSINESS

Overview

We were incorporated in Delaware in April 2005 as Online Music Corp. and changed our name to Digital Music Group, Inc. in September 2005. On February 7, 2006, concurrent with the closing of our initial public offering, we acquired Digital Musicworks International, Inc., a California corporation, and certain assets of Rio Bravo Entertainment LLC, a Delaware limited liability company, doing business as Psychobaby. Unless otherwise specified, the discussions in this Annual Report on Form 10-K prior to February 7, 2006 assumes the completion of such acquisitions.

We provide digital music recordings to online music stores for purchase by consumers. We have contractual rights to sell over 200,000 music recordings in digital format, approximately one-half of which were acquired in September 2005. We purchase, license or distribute music recordings in digital format under contracts with record labels, artists and other content owners. We process these recordings through our digital music processing system for delivery to leading and selected specialty online music stores through which our recordings become available for purchase via downloading. As of December 31, 2005, we had approximately 36,000 music recordings available for sale at online music stores, such as Apple iTunes Music Store, RealNetworks, Napster, Wal-Mart Music, MSN Music and Yahoo! Music. This number had increased to approximately 65,000 recordings as of March 20, 2006, and we are working to obtain delivery, process the remaining music recordings and make them available for sale as quickly as possible.

The recorded music industry has seen increasing demand for the purchase of digital music through online music stores and wireless channels, such as mobile phones. Online music stores offer the ability to make large numbers of recordings available to consumers for purchase at any time. Sophisticated online search tools permit

consumers of music and other sound recordings to identify and purchase many previously inaccessible recordings. However, only a fraction of known music recordings are currently available for purchase in digital format. We believe that many owners of music recordings have yet to make their recordings available in digital format because of the time, effort and cost involved. In addition, we believe many online music stores are reluctant to enter into relationships with holders of small numbers of music recordings because of the administrative costs involved.

Through online music stores, we provide consumers with access to music recordings, many of which are not readily accessible in traditional music retailers or otherwise available in digital format. In addition, we provide a means for music and other sound recording content owners to make their content available to consumers at online music stores with minimal effort on their behalf. Further, we reduce the burden for online music stores of managing individual relationships with numerous smaller content owners.

We receive revenue from the online music stores based on the number of times our music recordings are downloaded or listened to by consumers. For recordings for which we are the owner of the digital rights, we pay a royalty from our revenue to the artist and the publisher of the music recording. For each licensed or distributed music recording, we pay a negotiated portion of the revenue to the content owner and, if applicable under our contract with the content owner, we may also pay the royalty owed to the artist and/or the publisher of the music recording.

Our rights generally allow us to electronically distribute, market, promote and sell our music recordings, including by digital download and by digital audio transmission formats such as streaming media and downloads to mobile phones. The Internet and mobile technology now make it economically feasible for online music stores to make virtually an unlimited number of music recordings available to consumers for purchase at any time.

Our strategy is to rapidly acquire by purchase or license the digital rights to as many recordings as possible. We actively seek out the owners of music and other sound recordings for purposes of acquiring their digital rights. Our focus is on acquiring rights to music recordings from various genres and time periods but primarily back catalogue, out-of-print recordings, past hits, world music, classical music performances, previously unreleased music recordings, live performances, and other music that may no longer be readily available from traditional music retailers, as well as recent recordings by independent label artists. Other recordings we may acquire include music and audio or audio/video from live performances not previously commercially available, radio and television productions, and other sources as they are identified by us. We believe that market demand exists for such recordings.

Recent Developments

Concurrently with the closing of our initial public offering on February 7, 2006, we completed the acquisition of Digital Musicworks International, Inc., a California corporation, and certain assets of Rio Bravo Entertainment LLC, a Delaware limited liability company, doing business as Psychobaby. We acquired Digital Musicworks International, Inc. by way of merger and purchased certain assets of Rio Bravo Entertainment LLC consisting solely of agreements for digital distribution rights to music recordings and agreements with online music stores. We issued an aggregate of 2,275,000 shares of common stock to the shareholders of Digital Musicworks International, Inc. and to Rio Bravo Entertainment, LLC in connection with the acquisitions. The acquisitions were accounted for using the purchase method of accounting, with Digital Musicworks International, Inc. designated as the acquiror for accounting purposes.

Market Overview

The Emerging Digital Music Market

We believe the recorded music industry is undergoing significant change, with the primary means of distribution transitioning from physical formats like compact disc to digital formats accessed over the Internet

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and wireless and cable networks. We believe this change is occurring as a result of the popularity and proliferation of personal computers and portable digital music players like the Apple iPod and consumer acceptance and the music industry s endorsement of legitimate digital music sales.

Since Apple s introduction of the iPod in 2001, approximately 42 million iPods have been sold through December 2005, with approximately one-half of those sales occurring in the last six months of 2005. Worldwide shipments of portable digital music players are projected to grow from 26.4 million units shipped in 2004 to 124 million units in 2009, according to a recent market research report.

The legitimate digital music industry emerged in 2003 with the introduction of Apple iTunes and other online music stores. iTunes is the dominant online retailer with over 75% market share, although an increasing number of additional online music stores are opening or in the planning stages. We believe the digital music market is growing very rapidly as evident by its increase from 1% of the $32 billion worldwide recorded music market in 2004 to 6% of the market in 2005. The emergence of digital music has created additional opportunities for content owners in addition to the purchase of digital music and other sound recordings, such as ringtones and mastertones for mobile phones, and digital video downloads and other audio and video transmissions, such as music videos and television programs, through iPods and other digital music players and mobile phones.

Consumer Demand and Access to Digital Music

Consumers now purchase music in two principal formats, including physical formats such as compact disc from traditional music and e-commerce retailers and digital formats through pay-per-download or subscription services from online music stores.

Purchase of music in digital format offers many advantages to consumers over compact disc. Online music stores offer a larger music selection than traditional music retailers and also:

- offer the ability to sample all of their digital music selections before purchase;
- are accessible 24-hours every day;
- offer the ability to purchase music as a single instead of an entire album; and
- enable the purchase of music in an easily portable format that is not subject to degradation from use and handling.

When a consumer purchases digital music, they download a music recording from an online music store and are then able to listen to the music recording on their computer, transfer the music recording to a portable digital music player or transfer a copy of the music recording to compact disc for listening on compact disc players. Currently a digital music download from iTunes costs $0.99. Other online music stores, such as Wal-Mart Music and MSN Music, offer their music recordings for prices that currently range from $0.88 to $0.99.

Certain online music stores, such as Napster, Yahoo! Music and RealNetworks, also offer their music recordings on a subscription basis that allows consumers access to all of that store s recordings for prices that typically range from $4.99 to $9.99 per month. Following the termination of their subscription, consumers are not able to play these music recordings.

Consumers can also purchase music through their mobile phone by downloading a music recording or ringtone to their mobile phone from their service provider or an online provider of mobile ringtones, mastertones and similar products. These mobile offerings allow consumers to purchase and playback entire music recordings and music videos for a typical purchase price per recording ranging from $1.99 to $2.99.

A significant number of music recordings are not currently available for purchase in digital format. Gracenote, the leading industry music database, lists approximately 59 million music recordings in its database.

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However, as of September 2005, only approximately two million music recordings were currently available at iTunes. We believe that many of the music recordings not currently available are held by a disparate, fragmented group of content owners. Our experience is that these owners possess digital rights to libraries ranging from 100 recordings to tens of thousands of recordings.

Accessing the Digital Music Market by Content Owners

The digital music market represents a new opportunity for record labels, artists and other owners of music recordings, but also presents significant challenges.

To access this market, the content owner may be required to enter into separate agreements with each online music store they wish to sell their music recordings through. The leading online music stores have taken steps to limit the number of content owners with which they have direct relationships by, in certain cases, increasing the minimum number of music recordings required to establish a relationship. Our experience is that this threshold at the leading online music stores for holders of back catalogue, out-of-print recordings, past hits and independent label recordings is approximately 1,000 music recordings.

If a content owner is able to enter into an agreement with an online music store, they must then compile their music recordings descriptive information, including for example: music recording title, album title, artist name, year of original release, copyright information, songwriter information, publisher information and other related information required by the online music store. They also must submit their music recordings grouped into albums, and artwork in a digital file must be transmitted to the online music store for each album. In addition, the master music recordings may exist in physical formats based on old technologies, such as audio tape and vinyl records, that must be converted to compact disc or a computer file for processing.

Once their music recordings are available for purchase in digital format, each online music store delivers unique sales reports to the content rights owners that provide revenue and music recording usage data. Based on such reports, the rights owners of the music recordings must make royalty payments for publishing and other rights with respect to each digital music recording sold.

Depending on the available resources of the content owner, these processing and royalty payment steps may be technologically challenging, inconvenient and time consuming. As a result, many owners of music recordings have not yet undertaken the digitization and processing efforts necessary to offer their music recordings at online music stores.

Competitive Strengths

We increase the selection of music recordings available for purchase by consumers, we provide a means for content owners to access the digital music market with minimal effort on their behalf and we increase the number of music recordings for sale by the online music stores.

We address the needs of these market participants in the following manner:

Consumers. We increase the breadth of music and other sound recordings available to consumers for purchase by making available vintage content, music recordings that are out-of-print and music and other sound recordings that are no longer available or were never previously available in traditional music retailers or at e-commerce retailers.

Content Owners. We offer a convenient means by which record labels, artists and other owners of music recordings can access the digital music market. Content owners typically deliver to us the physical media containing their music recordings to convert into the unique digital formats required by the various online music stores. Historically, we have received most music recordings on compact disc. We can also assist content owners with any delivery and physical format conversion efforts by taking

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portable equipment we possess to the content owner s location for processing on-site by us. We also receive the periodic reports from the online music stores on behalf of the content owners that contain sales information for each of their recordings. Based on these reports, we prepare and provide summary reports to the content owners and pay the required royalties and revenue sharing payments.

Online Music Stores. We act as a volume supplier that aggregates digital music recordings from numerous content owners for the online music stores. We remove the need for online music stores to enter into and maintain relationships with the many independent labels and other music owners from whom we have acquired digital music rights. We also increase the number and diversity of music recordings available for sale by the online music stores.

Growth Strategy

We seek to acquire perpetual or long-term license of digital rights to as many music and other sound recordings as possible, on terms that we deem commercially reasonable. Once acquired, we seek to make these recordings available to consumers by placing them on leading and selected specialty online music stores.

We attempt to meet these objectives by pursuing the following strategies:

Expand our library of digital music and other sound recordings. We actively seek to identify the owners of music and other sound recordings and attempt to acquire the exclusive digital rights to such recordings. We focus on acquisition by purchase or long-term license of the digital rights to music recordings from owners of large numbers of recordings. We also allow owners of fewer recordings, including independent record labels seeking exposure for the music of current artists and artists themselves, to provide us with their music recordings for distribution in a cost-effective manner through our web-based self-service application called the Digital OnRamp. We use our network of contacts in the music industry to identify and locate owners of content.

Increase sales channels. We generate revenue from our digital music rights by entering into agreements with online music stores that sell our music recordings to consumers. We currently have contractual relationships with leading online music stores, including those offering digital downloads on a pay-per-download basis and digital music subscription services. We intend to pursue other outlets for our digital rights as they become commercially viable.

Repackaging our digital music content. We create theme-based compilations and other combinations of our digital music recordings for sale at the online music stores to increase the number of digital downloads of certain of our music recordings. Our experience has been that such efforts have provided a competitive advantage when negotiating agreements with content owners and have increased the placement of our content on certain of the online music stores.

Develop and expand our technologies. We seek to purchase additional equipment and software and continue to expand and develop our own technologies for use in our business to more efficiently process and more effectively market our music recordings and produce more informative summary reports.

Content Acquisition

We acquire digital rights to music recordings as follows:

Purchase of digital rights. In exchange for the purchase of digital rights, we generally pay a fixed sum of money or we can use a combination of our common stock and cash as the purchase consideration. This amount is generally larger than would be bargained for when we acquire such rights through a long-term license. However, we retain all revenue received with respect to purchased digital rights, after payment of any required artist and statutory publishing royalties. The acquisition costs are amortized on a straight-line basis over the shorter of the term of the related agreement or seven years.

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Long-term license. We obtain long-term licenses to digital rights. Our licenses currently have terms of seven to ten years, typically with renewal options. After the term of the license, all rights revert to the licensor. In exchange for long-term licenses, we generally pay a fixed sum of money in the form of an advance against future sales royalties or fees to be paid to the content owner. After recoupment of our initial fixed payment, we generally continue to pay revenue sharing fees to the content owner in accordance with the terms of our agreements with content owners.

Short-term distribution rights. We obtain short-term digital rights through distribution agreements with content owners. After the term of the agreement, we do not retain any continuing rights unless the agreement is renewed. Distribution agreements generally do not require us to make upfront or fixed payments. Instead, upon receipt of revenue from sales by the online music stores, we pay all revenue to the content owner other than a distribution fee which we retain in accordance with the distribution agreement with the content owner. We retain a smaller portion of the revenue received from online music stores under distribution agreements than under long-term license agreements or with respect to rights we have purchased. We seek to enter into distribution agreements with a two-year term.

Acquisition. We may in the future acquire companies that own master music recordings, which would give us all rights to such recordings, including digital formats, physical formats and licensing for compact disc compilations, motion pictures, television programs and commercials. Such transactions are likely to be more costly and time-consuming than the other methods by which we acquire digital rights to music recordings. We may use our common stock in addition to cash for the consideration for any such future acquisitions.

For the year ended December 31, 2005, we have generated 22% of our revenue from music recordings for which we purchased the digital rights, 42% of our revenue from music recordings to which we have long-term licenses, and 36% of our revenue from music recordings for which we have short-term distribution rights. We expect these percentages to change in the future and for our revenue under short-term distribution agreements to become a smaller part of our total revenue, because we have the digital rights to a substantial number of additional music recordings that have not yet been made available for sale at online music stores as of December 31, 2005, which have been purchased or acquired under long-term licenses.

Our Content

Through December 31, 2005, we have entered into five agreements for the perpetual and long-term digital license rights to approximately 35,000 and 158,000 music recordings, respectively, and more than 90 agreements for short-term distribution rights to over 7,000 music recordings. As of December 31, 2005, approximately 36,000 of our music recordings had been made available by us to leading and selected specialty online music stores for purchase by consumers. This number of recordings made available to online music stores has increased to approximately 65,000 as of March 20, 2006. Our remaining music recordings as of that date were either not yet received by us from the content owners or not yet processed by us for delivery to online music stores.

The music rights that we acquire are contractual and based upon the rights granted to us by the content owner who may not be the original rights owner. Our agreements with the content owners require that they assure us that they have proper title and ownership to the digital rights acquired by us. We perform what we believe to be a reasonable amount of diligence on the ownership of music recordings by the record labels and catalog owners from whom we acquire digital rights. We also rely on representations and warranties and indemnities provided to us by the owners as to ownership. Given the contractual nature of our rights and our acquisition of older music recordings, there are no assurances that we may not receive a claim from a third party challenging our rights and be required to incur expense to defend those rights and be liable for any damages.

Our music recordings are from various genres and time periods and primarily include back catalogue, out-of-print recordings, past hits, world music, classical music performances, previously unreleased music recordings, live performances, and other music that may no longer be readily available from traditional music

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retailers, as well as recent recordings by independent label artists. Other recordings we may acquire include music and audio or audio/video from live performances not previously commercially available, radio and television productions, and other sources as they are identified by us.

Our music recordings are available at leading online music stores, including Apple iTunes Music Store, Real Networks, Napster, Wal-Mart Music, Yahoo! Music, MSN Music and other online music stores. These online music stores collectively offer music recordings in over 20 countries. Our music recordings are currently offered in some, but not all, of these countries. For the year ended December 31, 2005, 88% of our revenue was generated in the United States with the remaining 12% coming from online music stores serving customers in Europe, Japan and Canada.

There is no assurance as to the timing when the additional music recordings under contract can be made available for purchase at the online music stores or that they will be as popular with consumers and generate revenue at the same rate as those currently available for purchase.

Content Processing and Operations

Upon entering into a digital rights acquisition agreement with the content owner, the following principal steps are involved to make our music recordings available for purchase at an online music store:

We must receive the content. The content owner is required to deliver their music recordings to us, along with descriptive data with respect to each music track, such as music recording title, album title, artist name, copyright information, songwriter information, publisher information, territorial rights and other related information. Our perpetual and long-term license rights agreements generally provide for delivery of music recordings in physical format in specific batches over time. Our goal is to add internal resources and offer to assist these content owners in delivering their music recordings and all the necessary descriptive data to us. Content owners who enter into short-term distribution agreements with us can provide their music recordings to us through our convenient online service called Digital OnRamp.

The music recordings must be processed by us and delivered to the online music stores. Following receipt of the music recordings in physical format, we convert them into the specific digital formats required by the various online stores. We then compile the required music recording descriptive information as specifically required by each online music store. iTunes and most other online music stores require that music tracks be batched together into an album format with artwork for each album. If the music recordings are already grouped into previously-issued albums when we receive them, we retain this album concept and utilize album cover artwork provided by the content owner. However, if the individual tracks are not grouped into an album, such as previously unreleased studio music recordings or a live concert recording, we bundle the various tracks into albums and develop artwork for the newly created album. Once complete, we deliver these music recordings in digital format, together with their associated descriptive information and album artwork, to the online music stores to be made available for purchase in the specific territories where we have acquired the digital rights.

The online music stores then make these available for purchase by consumers. Upon receipt, the online music stores review our music recordings, descriptive information and artwork to ensure that they are in the proper format for their store. Once approved, the recordings are then made available online for purchase by consumers.

Agreements with Online Music Stores and Content Owners

Pursuant to the terms of our agreements with the online music stores, we receive periodic sales and download activity reports, generally on a monthly basis within 30 days following the end of the month. We receive payment at approximately the same time as we receive these reports.

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The amount paid to us per download is negotiated in advance at the time we enter into an agreement with an online music store. For the year ended December 31, 2005, approximately 87% of our total revenue was generated through Apple iTunes, the largest online music store. Our agreements with Apple have terms of three years ending in April 2007. Under these agreements, Apple is required to pay us an agreed upon wholesale price for each recording sold on iTunes, which is currently $0.70 for each individual music recording downloaded and $7.00 for each album download. Although we negotiate with each store separately, our experience is that, of the retail price charged to consumers (currently $0.99 per individual download and $9.99 per album download at iTunes), the percentage paid to the rights holders per download does not vary significantly across online music stores. For subscription-based online music stores, such as Napster and RealNetworks, in addition to receiving an agreed upon wholesale price for each paid download sold by the store, we also receive a percentage of the subscription revenue realized by the online music stores based on the number of times our music recordings are listened to or downloaded by subscribers as compared to the total for all music recordings listened to or downloaded during the relevant time period.

We are responsible under our agreements with content owners for certain payments based on the periodic sales reports received from the online music stores. Based on the specific agreement with the content owner, these can consist of royalties to artists and/or publishers (which includes songwriters) and revenue sharing payments to the content owner. When we acquire digital rights, we have no influence over the terms as stipulated in the original recording contract between the content owner and artists or publishers. Our experience in acquiring digital rights on a perpetual basis is that the content owner will typically require us to assume and pay these royalty obligations to artists and publishers. The artist royalty obligations in these situations have historically been between 0% and 15% of the revenue attributable to a specific track or album. The publisher royalties are a statutory rate in the United States, which was $0.085 per music recording sold during 2005, increased to $0.091 in January 2006. Our experience in acquiring digital rights under a long-term license agreement is that the content owner typically requires us to assume and pay the royalties to publishers, whereas the content owner typically retains the artist royalty obligation.

Our long-term license and short-term distribution agreements contain revenue sharing provisions between the content owner and us. In the long-term license agreements we have entered into through December 31, 2005, the content owners receive 25 to 50% of the revenue earned (after deductions for publisher royalties paid by us) over the term of the agreement. In most cases, as an inducement to enter into the long-term license agreement, we will make a royalty advance to the content owner against the content owner s share of future royalties under this revenue sharing arrangement. Such advances are recouped from the content owners share of future revenue. In short-term distribution agreements, we are not responsible for any artists or publishers royalties and we make no upfront or fixed payments to the content owner at the time we enter into the agreement. Therefore, the revenue sharing percentage retained by the content owner (generally 80% to 85%) is substantially higher than under long-term license agreements.

Distribution and Marketing

We distribute our digital music recordings primarily to leading online music stores and to selected specialty online music stores that offer our music recordings for sale to consumers in those territories where we hold rights. We believe we have strong business relationships with iTunes and other online music stores to whom we provide music recordings for sale. Our music recordings have received premium placement on certain online music stores.

The flexibility of the digital format allows us to market our music recordings in creative ways by mixing-and-matching our individual recordings to create new digital music albums. With this flexibility, we are able to offer our music recordings in new compilation albums to attract consumers of a particular lifestyle or age group or related to an event type, holiday or live music concert, for example.

We expect to enter into co-marketing agreements with certain consumer or retail companies in order to market our music recordings directly to consumers, who will be encouraged to purchase these recordings at an

online music store. We expect these co-marketing programs to be structured in various ways and incorporate revenue sharing arrangements. In addition, we expect to market our services to content owners through advertising in trade publications, attendance at trade shows and event sponsorships.

Competition

We compete with numerous companies to acquire digital rights to music recordings and with traditional music retailers and online music distributors for consumer purchases of music recordings.

We compete with The Orchard Enterprise, Inc., Independent Online Distribution Alliance, Digital Rights Agency, IRIS and other companies to acquire digital rights to distribute music and other sound recordings. We understand that these companies seek to enter into short-term distribution agreements with content owners and do not offer content owners the perpetual or long-term license terms we seek. We compete for these short-term distribution rights on the basis of payment terms, processing services, marketing ability and reporting services. We are unable to anticipate which other companies are, or are likely to be, seeking to acquire digital rights to the same music recordings we may wish to acquire. We believe that the proceeds received in our initial public offering will allow us to compete favorably in the acquisition of additional digital rights to music recordings.

There are over two million music recordings available at Apple iTunes Music Store. We compete at iTunes and other online music stores for consumers attention and download expenditures with the four major record labels, Warner Music Group, EMI Group, Universal Music Group and Sony BMG Music Entertainment, who together represent over 70% of the current music market, as well as the other larger labels that directly place their music recordings in online music stores. Other than certain independent record labels and artists who provide us with the digital rights to their current albums under short-term distribution agreements, the music recordings for which we hold digital rights and to which we will seek to acquire digital rights in the future are not the current mainstream and popular hits, like those held by these major and other record labels. These companies have significantly better brand recognition, longer operating histories and significantly greater financial, marketing and other resources than us, and may be able to enter into strategic or commercial relationships with the online music stores that are competitively beneficial to them.

The market for digital music recordings is currently a small percentage of total revenue from the sale of music recordings. The compact disc remains the predominant media for music distribution, although we believe the recorded music industry is in the early stages of a transition from physical formats to digital formats. We believe that the market share of digital music will increase and digital formats will ultimately become the preferred way consumers purchase and listen to music.

New technologies and the continued enhancement of existing technologies may also increase competitive pressures on our company. We cannot assure you that we will be able to successfully compete against current and future competitors or adequately address increased competitive pressures. See Risk Factors.

Intellectual Property

We rely on a combination of trade secret, copyright and trademark laws in the United States and other jurisdictions, as well as confidentiality provisions and contractual restrictions, to protect our proprietary rights, including our know-how.

We have filed trademark applications for the names Digital Music Group and Digital Musicworks International as well as for the trademarks DMG, Digital OnRamp and our logo design.

Employees

As of March 20, 2006, we had 15 full-time employees. Among these employees, three were senior management, four were in business development, four were in accounting and administration, and four were in

operations. None of these employees are covered by a collective bargaining agreement and we have never experienced a work stoppage. We consider our relations with our employees to be good. We intend to increase the number of our personnel substantially over the next twelve months.

Other Information

Our principal executive offices are located at 1545 River Park Drive, Suite 210, Sacramento, California 95815 and our telephone number at that location is (916) 239-6010. We have entered into a new lease effective April 1, 2006, to move our principal executive offices to 2151 River Plaza Drive, Sacramento, California 95823. Our website is located at *www.digitalmusicgroupinc.com*. The contents of our website is not incorporated by reference in this Annual Report on Form 10-K.

Our investor relations website is located at *http://investor.digitalmusicgroupinc.com.* Copies of our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to these reports are available, free of charge, on our investor relations website under the link SEC Filings as soon as reasonably practicable after such material is electronically filed with the Securities and Exchange Commission. The Securities and Exchange Commission also maintains a website that contains our filings at *www.sec.gov*.

Item 1A. RISK FACTORS

In addition to the other information contained in this Annual Report on Form 10-K, we have identified the following risks and uncertainties that may have a material adverse effect on our business, financial condition, or results of operation. Investors should carefully consider the risks described below before making an investment decision. The trading price of our common stock could decline due to any of these risks, and investors may lose all or part of their investment.

We have a limited operating history and have experienced net losses to date and we may not be able to become profitable or generate positive cash flow in the future.

You should consider our business and prospects in light of the risks, expenses and difficulties encountered by companies in their early stage of development in a rapidly evolving industry. Digital Music Group, Inc. was formed in April 2005 and had no operations prior to the acquisitions of Digital Musicworks International, Inc. and certain assets of Rio Bravo Entertainment LLC in February 2006, other than in connection with the acquisitions and our initial public offering. As a pro forma combined entity, we have experienced net losses of approximately $2.3 million from inception through December 31, 2005, and we have not yet been able to generate positive cash flow from operations. We cannot be certain that we will be able to generate net income and positive cash flow from operations in the future.

As a result of our limited operating history, we may fail to meet our forecasts or the expectations of securities analysts or investors, which could cause our stock price to decline.

Our limited operating history and the rapidly evolving nature of our industry make forecasting quarterly and annual operating results difficult. We may not be able to quickly reduce spending if our revenue is lower than we project. Any significant increase in our expenses or shortfall in our revenue would be detrimental to our business, operating results and financial condition and could cause our results of operation to fall below the expectations of public market analysts and investors. As a result, you should not rely on our historical results as an indicator of our future performance.

If we are unable to successfully integrate the operations of Digital Musicworks International, Inc. and the acquired assets of Rio Bravo Entertainment LLC, our revenue and results of operations could be adversely affected.

Our costs of operations will increase if we are unable to successfully combine the acquired operations of Digital Musicworks International, Inc. and assets of Rio Bravo Entertainment LLC or integrate the systems and procedures, including accounting, financial reporting and information technology of the combined entity. Our financial results cover periods during which we were not under common control or management and, therefore, may not be indicative of our future financial or operating results. Our failure to integrate Digital Musicworks International, Inc. and the acquired assets of Rio Bravo Entertainment LLC and obtain all the benefit of the content license agreements and employee and business relationships of Digital Musicworks International and Rio Bravo Entertainment LLC could impair our future revenue and results of operations.

Our business depends on our ability to identify and locate the holders of digital rights to additional music recordings, and failure to do so will limit our revenue growth.

Our goal is to continue to acquire digital rights to music recordings in order to substantially increase our revenue. Ownership of music recordings is highly fragmented and not organized in a common marketplace. There is no registry or directory of the holders of digital rights to music recordings that we may wish to acquire. Finding the owners of music recordings and associated digital rights can be difficult and time-consuming. We currently rely on our network of relationships and market research to locate content owners. In the future, our ability to continue to identify and locate such content owners will have a significant impact on the amount of content we are able to acquire.

Our inability to enter into agreements to acquire additional digital rights to music recordings on commercially favorable terms could impede our growth and increase our expenses.

Our business is dependent on our ability to acquire digital rights to additional music recordings. Even if we are able to locate additional content owners, they may not be willing to sell or license the digital rights to their music recordings or we may not be able to negotiate terms that are commercially favorable to us. While we believe that our experience and knowledge in the music industry and our operating history allows us to determine commercially reasonable prices, we may be unable to objectively determine fair market value for the digital rights to music recordings that we acquire because of unknown consumer demand for such recordings, unknown number of additional owners of digital rights to such recordings in certain cases and absence of independent valuations for these music recordings. If these content owners are unwilling to sell or license their rights on terms that we have determined are commercially favorable to us, we will not be able to substantially increase our revenue.

We face competition from companies seeking to acquire the digital rights to music recordings, which could negatively impact our ability to acquire additional digital rights to music recordings.

The market for acquiring digital rights from content owners is competitive, although the majority of our known current competitors are focused on short-term distribution arrangements, whereas our focus is on acquiring digital rights under long-term license or purchase agreements. The number of commercialized music recordings available for acquisition is large, but limited. We expect to face competition in our pursuit to acquire additional music recordings, which may limit the number of available music recordings for sale or license and may lead to higher acquisition prices. Our competitors may from time to time offer better terms of acquisition to content owners. Several of our competitors have longer operating histories, larger customer bases, greater brand recognition and greater financial, marketing and other resources than we do. Some of our competitors have adopted, and may continue to adopt, aggressive pricing policies and devote substantially more resources to acquiring digital rights to music recordings. In addition, our competitors may form strategic alliances with record labels and online music stores that could result in increased competition for the acquisition of music recordings, service offerings or favorable terms with the online music stores. Increased competition for the acquisition of digital rights to music recordings may result in a reduction in our operating margins, market share and brand.

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We may acquire record labels or other companies that own master rights to music recordings, and if we are unable to successfully acquire or integrate these companies, we may not be able to acquire additional recordings or grow our revenue.

We may attempt to acquire record labels or other companies that own master rights to music recordings for purposes of acquiring their digital rights. If we are not able to successfully acquire such companies, we may not be able to acquire additional recordings or grow our revenue. In the event we are able to acquire other companies, we may be subject to a number of risks related to the integration and management of such companies, including failure to obtain valid consents to assignment of contracts, including contracts granting rights to music recordings, failure of the business of the acquired company to achieve expected results, diversion of management s attention, and failure to retain key personnel of the acquired company. In addition, if we undertake an acquisition of a company that owns digital and other rights to music recordings, we may attempt to operate the non-digital businesses or sell the non-digital rights to another person or entity, and we may not be able to do so in a manner or on terms favorable to us.

If the music recordings that we provide to the online music stores do not appeal to consumers tastes and preferences, our revenue will decrease.

Our success depends on our ability to acquire and offer for purchase music recordings that appeal to consumers tastes and preferences. Consumers tastes are subject to frequent, significant and sometimes unpredictable changes. We cannot accurately assess or control consumer demand for our music recordings. We do not own rights to current popular hits and may never acquire rights to these music recordings. Our historical sales are based on a limited library of music recordings available for purchase at the online music stores. In the future, our current music recordings and the additional music recordings we make available for purchase may not experience similar demand. Any reduction in the number of downloads of our music recordings by consumers will cause a reduction in our revenue.

The digital music industry is in its infancy and we are vulnerable to discounting, price-reductions, pricing structure and stocking changes that may evolve in the industry and as a result, cause a reduction in our revenue.

We receive revenue based on the wholesale prices determined by the online music stores based, to a large extent, on the price charged to consumers by the online music stores. Currently, the largest online music store, iTunes, charges consumers $0.99 per music recording download. We believe certain major record labels in the music industry are attempting to change the online pricing model so that the price for current popular hits will be over $1.00, while older or less current music recordings will be sold for less. Because we are primarily focused on acquiring or licensing the digital rights to independent label, back catalogue, past hits and out-of-print music recordings and are not focused on current popular hits we would be subject to any such unfavorable pricing changes. We have limited ability to influence the pricing models of the online music stores. If the online music stores adopt a lower pricing model for our music recordings or if there is a pricing structure change to a flat-fee subscription or other similar pricing models, we may receive substantially less per download for our music recordings, which could cause a material reduction in our revenue, unless it is offset by a corresponding increase in the number of downloads. Additionally, Apple iTunes and other online music stores at present accept and post for sale all the music recordings that we and other distributors deliver to them. However, if online stores in the future decide to limit the types or amount of music recordings they will accept from digital music content owners and distributors like us, our revenue could be significantly reduced.

We are substantially dependent on a limited number of online music stores, in particular Apple iTunes Music Store, for the sale of our music recordings.

We derive our revenue from a small number of leading online music stores that sell to consumers the digital music recordings that we acquire or control through licenses. For the year ended December 31, 2005, we received 87% of our revenue from iTunes, compared to 93% of our revenue from iTunes for the year ended December 31,

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2004. Our agreements with Apple iTunes have terms of three years ending in April 2007. Under the terms of the agreements, Apple is required to pay us an agreed upon wholesale price for each recording sold by Apple. If we are not able to renew our relationship with iTunes and other online music stores that offer our music recordings for sale on similar economic terms, our ability to generate revenue will be significantly reduced.

Our accounts receivable are concentrated with a limited number of online music stores, particularly Apple iTunes, which subjects us to substantial payment risk.

We rely on reports from the online music stores detailing download activity to determine our revenue, and such reports are typically provided to us within 30 days following the end of the month. We receive payment at approximately the same time as we receive these reports of download activity. Our accounts receivable therefore consists of approximately one month s revenue. We currently have music recordings for sale at 10 online music stores, and as of December 31, 2005, accounts receivable from Apple iTunes Music Store represented 81% of our total accounts receivable, compared to 76% of our total accounts receivable as of December 31, 2004. This concentration of accounts receivable among a small number of online music stores is likely to continue and we expect our accounts receivable to become larger as we grow. If any of these online music stores are unable to pay us as due each month, it could disrupt our business and cause us to report a bad debt loss.

Other parties may have digital rights, or claim to have such rights, to our music recordings, which may result in duplicates of the music recordings we sell to be available for purchase at the online music stores and cause a reduction in our revenue.

We generally acquire all of the digital rights that the content owner of music recordings has available to grant; however, the holders of such rights may not possess exclusive rights to those music recordings. We are unable to determine the number of additional holders of rights to our music recordings. Aside from copyright law, the rights to music recordings are contractual in nature. There is no central registry that evidences the chain of title to the rights of music recordings other than copyright registration, which is voluntary. Given the age of many of the music recordings we have or may acquire, there is often a lack of documentation to evidence the chain of title of rights we acquire. In addition, there is a common practice in the music industry of licensing rights in various formats or in certain compilations and to grant the same rights to different parties for the same or different geographic regions. Our content acquisition agreements contain representations, warranties and indemnities only with respect to the digital rights granted to us and not with respect to the rights held by other parties. Because more than one party may have the right to sell the same music recording, we have acquired, and we expect in the future to acquire, rights to multiple copies of the same music recording. In such instances, we become entitled to payment for download activity for both copies, to the extent they are both purchased by consumers at the online music stores. Additionally, we are aware of numerous instances where other parties have digital rights to the same music recordings to which we have digital rights. If copies of our music recordings are available at the online music stores from alternative sources, our revenue will be reduced to the extent these copies are purchased instead of ours.

We may not receive legal title to the digital rights of music recordings that we have paid to acquire, and any determination that we don t hold such rights may subject us to damages for revenue received.

Our agreements contain representations, warranties and indemnities with respect to the digital rights granted to us. In at least one instance, we purchased digital rights that were determined not to be held by the holder from whom we acquired those rights. If we were to acquire and make available for purchase music recordings from a person who did not actually own such rights, our business would be adversely affected. We would lose the rights to sell such music and might be subject to copyright infringement lawsuits for selling such music recordings without the right to do so. Finally, it could materially impact our reputation with content owners and our relationships with online music stores, which could adversely affect our business.

If there are long delays in the time it takes to receive the music recordings that we acquire rights to, our revenue growth will be negatively impacted and our cash flow will be affected adversely.

Implementation of our business plan and growth strategy depends on increasing the number of music recordings we have available for purchase by consumers at the online music stores. Our purchase and long-term license agreements typically require the content owners of the music recordings to deliver to us their music recordings. Under our short-term license agreements, there are no delivery terms. Certain of the music recordings we acquire may be in older physical formats such as audio tape or vinyl records that require processing onto compact disc prior to being delivered to us. In addition, our agreements require that certain descriptive information required by the online music stores for each music recording be delivered with the music recordings, such as recording title, album title, artist name, genre, copyright information, label name, unique product identifier, artwork, biographical information, sales information and date of release. Historically, it has at times taken several months or longer after we have entered into an agreement before we have received delivery of all of the music recordings acquired. Although we generally specify delivery dates and make certain cash payments by us conditional upon delivery, we do not have control over the timing for receipt of the music recordings acquired. If there are long delays in the time it takes for the content owners to deliver to us the music recordings in physical format and the related descriptive information, it will delay our ability to begin the process of converting the music recordings into the digital formats required by the online music stores. It could also cause inefficiencies in the utilization of our operations personnel who process these recordings. Any delay in making our music recordings available for purchase at the online music stores will delay our revenue growth, and inefficiencies caused by such delays could cause a reduction in our cash flow in the interim.

We have entered into multi-year agreements for digital rights to music recordings and if we are unable to renew these agreements on commercially favorable terms once they expire, our revenue could materially decrease.

Our long-term success depends upon, among other things, our ability to renew our non-perpetual rights to music recordings once they expire. If any of our competitors offer better terms, it will cause us to spend more money or grant better terms, or both, to renew the rights we currently hold. If we are unable to renew the non-perpetual rights to our music recordings on commercially favorable terms, our revenue could materially decrease.

If we are not able to scale our reporting and payment processes, we may experience delays providing reports to the content owners and paying required royalties that could have a negative effect on our brand identity.

We receive regular sales reports from online music stores that contain sales information for each of our music recordings. Based on these reports, we provide summary reports to the content owners. When we acquire the perpetual digital rights to music recordings and in certain of our license agreements, we may assume the obligations of the content owner to pay any required royalty payments to the artists according to the terms of the existing agreements. In addition, we may be required to pay statutory publishing royalties on behalf of the content owner according to the terms of our agreements. We have not fully implemented the systems required to process these royalties. We have accrued for future payment of royalties based on our calculations of such amounts due, but have not paid any of these amounts. As we acquire digital rights to additional music recordings, we may experience difficulties in preparing and distributing sales reports for the content owners or processing and paying artist and publishing royalties in a timely fashion. If we are not able to successfully expand our processing capability or introduce technology to allow us to determine and pay royalty amounts due and automate these tasks, we may experience delays as we increase the number of our music recordings, which could have a negative effect on our relationships with content owners and brand identity.

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The loss of one or more of our key personnel, or our failure to attract, assimilate and retain other highly qualified personnel in the future, could cause a disruption in our relationships with the online music stores and content owners.

We depend on the continued services and performance of our key personnel, including Mitchell Koulouris, our Chief Executive Officer and President. Although we have employment agreements with our executive officers, they may decide to terminate their employment or otherwise cease to be employed by us. We do not have key person life insurance for any of our personnel. As we grow, our business will be dependent on our ability to recruit, employ and retain additional management and other skilled personnel. The loss of the services of any of our key personnel or the failure to attract other key personnel could disrupt and limit our ability to grow our business.

Piracy is likely to continue to negatively impact our potential revenue.

Our revenue comes from the sale of our digital music recordings over the Internet and wireless and cable networks, which is subject to unauthorized consumer copying and widespread dissemination on the Internet without an economic return to us. Global piracy is a significant threat to the music industry generally and to us. Unauthorized copies and piracy have contributed to the decrease in the volume of legitimate sales of recorded music and have put pressure on the price of legitimate sales.

We face a potential loss of music recordings if it is determined that recording artists have a right to recapture rights in their recordings under the U.S. Copyright Act.

The U.S. Copyright Act provides authors and their heirs a right to terminate licenses or assignments of rights in their copyrighted works that were not works made for hire . If any of our music recordings were determined not to be works made for hire , then the recording artists or their heirs could have the right to terminate the rights we hold. These residual author rights generally survive for five years after the end of the 35-year period from the date of a post-1977 license or assignment, and in the case of a pre-1978 grant in a pre-1978 recording, five years after the end of the 56-year period from the date of creation or January 1, 1978, whichever is later. Any termination of our rights to our music recordings could have a material reduction in our revenue.

We may need to raise additional capital to accomplish our objectives of acquiring the digital rights to music recordings, and if we are unable to raise such money as needed our growth would be limited.

We intend to use our common stock and cash for the consideration for future acquisitions of digital rights to additional music recordings. If our common stock does not maintain a sufficient market value or content owners are unwilling to accept common stock as part of the consideration for the sale of the digital rights to their music recordings or of their businesses or as consideration for licensed rights to their music recordings, we may be required to utilize more of our cash resources, if available. Although we currently anticipate that the proceeds from our February 2006 initial public offering of common stock, together with our available funds, will be sufficient to meet our cash needs for 2006, we may require additional financing in the future. If we do not have sufficient cash resources, our ability to acquire additional rights to music recordings could be limited unless we are able to obtain additional capital through future debt or equity financings. Our ability to obtain financing will depend, among other things, on our development efforts, business plans, operating performance and condition of the capital markets at the time we seek financing. Additional financing may not be available to us on favorable terms when required, or at all. Using cash to finance acquisitions could substantially limit our financial flexibility and using debt could result in financial covenants that limit our operations and financial flexibility. If we raise additional funds through the issuance of equity, equity-linked or debt securities, those securities may have rights, preferences or privileges senior to the rights of our common stock, and our stockholders may experience dilution.

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If the Internet and portable digital music players cease to be the medium accepted by the mass market for digital music, our business could be affected adversely.

Our success depends to a substantial extent on the willingness of consumers to increase their use of online services as a method of purchasing music. The use of the Internet to select and download purchased music is growing rapidly but is still evolving, and it is uncertain whether this market will achieve and sustain high levels of demand and market acceptance. If the use of the Internet to select and purchase music recordings does not gain in popularity and market acceptance, our business could be affected adversely. Much of our revenue is tied to the popularity of portable digital music players like the iPod by Apple Computer and other digital music listening devices. If the market penetration by these devices does not continue, the number of consumers purchasing digital music may decrease or not grow, which could result in a reduction in our revenue.

Our officers and directors and their affiliates will exercise significant voting control over us as stockholders.

Our officers and directors and their immediate family members, as of March 20, 2006, beneficially owned, in the aggregate, approximately 29% of our outstanding common stock. See our Proxy Statement for our 2006 Annual Meeting of Stockholders for the individual beneficial ownership of our common stock held by our directors and officers. These significant stockholders may have interests that are different from yours. As a result of their shareholdings, these individuals will be able to exercise significant control over matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions.

Provisions in our charter documents and under Delaware law could discourage a takeover that stockholders may consider favorable.

Our charter documents may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable because they:

- authorize our board of directors, without stockholder approval, to issue up to 1,000,000 shares of undesignated preferred stock; and
- establish advance notice requirements for proposing matters to be approved by stockholders at stockholder meetings.

As a Delaware corporation, we are also subject to the Delaware anti-takeover provisions contained in Section 203 of the Delaware General Corporation Law. Under Delaware law, a corporation may not engage in a business combination with any holder of 15% or more of its capital stock unless the holder has held the stock for three years or, among other things, the board of directors has approved the transaction. Our board of directors could rely on this provision to prevent or delay an acquisition of us.

Our stock price is subject to fluctuation and could decline.

The price at which our common stock has traded since our initial public offering in February 2006 has fluctuated significantly. The price is likely to continue to fluctuate significantly due to the following factors, some of which are beyond our control:

- variations in our operating results;
- variations between our actual operating results and the expectations of securities analysts, investors and the financial community;
- announcements of developments affecting our business, systems or expansion plans by us or others; and
- conditions and trends in online commerce industries, particularly in the online digital music market.

As a result of these and other factors, investors in our common stock may not be able to resell their shares at or above their purchase price.

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In the past, securities class action litigation often has been instituted against companies following periods of volatility in the market price of their securities. This type of litigation, if directed at us, could result in substantial costs and a diversion of management s attention and resources.

Future sales of our common stock, including those purchased in our recent initial public offering, may depress our stock price.

Sales of substantial amounts of our common stock by our existing stockholders in the public market following the expiration of lock-up agreements entered into in connection with our initial public offering completed in February 2006 and compliance with Rule 144 hold periods may adversely affect the market price of our common stock. Shares issued upon the exercise of outstanding options also may be sold in the public market. Such sales could create the perception to the public of difficulties or problems with our business. As a result, these sales might make it more difficult for us to sell securities in the future at a time and price that we deem necessary or appropriate.

We do not intend to pay dividends.

We have never declared or paid any cash dividends on our capital stock and do not intend to pay dividends in the foreseeable future. We intend to invest our future earnings, if any, to fund our growth. We cannot assure you that you will receive a return on your investment when you sell your shares or that you will not lose the entire amount of your investment.

Our internal controls over financial reporting may not be adequate and our independent auditors may not be able to certify as to their adequacy, which could have a significant and adverse effect on our business and reputation.

We are in the process of documenting and evaluating our internal controls over financial reporting in order to allow management to report on, and our independent auditors to attest to, such controls, as required by Section 404 of the Sarbanes-Oxley Act of 2002 and rules and regulations of the Securities Exchange Commission thereunder, which we refer to as Section 404. Section 404 requires a reporting company to, among other things, annually review and disclose its internal controls over financial reporting, and evaluate and disclose changes in its internal controls over financial reporting quarterly. We will be required to comply with Section 404 for our fiscal year ending December 2007. We are currently performing the systems and process documentation, evaluation and testing required (and any necessary remediation) in an effort to comply with management certification and auditor attestation requirements of Section 404. In the course of our ongoing evaluation, we may identify areas of our internal controls requiring improvement, and plan to design enhanced processes and controls to address issues that might be identified through this review. As a result, we expect to incur additional expenses and diversion of management s time. We cannot be certain as to the timing of completion of our documentation, evaluation, testing and remediation actions or the impact of the same on our operations and may not be able to ensure that the process is effective or that the internal controls are or will be effective in a timely manner. If we are not able to implement the requirements of Section 404 in a timely manner or with adequate compliance, our independent auditors may not be able to certify as to the effectiveness of our internal control over financial reporting and we may be subject to sanctions or investigation by regulatory authorities, such as the Securities and Exchange Commission. As a result, there could be an adverse reaction in the financial markets due to a loss of confidence in the reliability of our financial statements. In addition, we may be required to incur costs in improving our internal control system and the hiring of additional personnel. Any such actions could adversely affect our results.

Item 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

Item 2. PROPERTIES

Our executive offices are located in Sacramento, California, where we lease approximately 3,500 square feet under an agreement that expires effective March 31, 2006. We recently entered into a 38 month lease effective April 1, 2006 for new office space of approximately 9,000 square feet in Sacramento, California. We believe this new office space will be suitable and adequate for our needs over the next twelve months.

Item 3. LEGAL PROCEEDINGS

We are currently not a party to any legal proceedings.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

PART II

Item 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Price Range of Common Stock

Our common stock is quoted on the Nasdaq National Market under the symbol DMGI. Our initial public offering was February 2, 2006 at $9.75 per share. Prior to February 2, 2006, there was no public trading market for our common stock.

Holders of Record

At March 27, 2006, the last reported sales price of our common stock on the Nasdaq National Market was $9.56 per share, and the number of holders of record was 114. Because many of our shares of common stock are held by brokers and other institutions on behalf of stockholders, we are unable to estimate the total number of stockholders represented by these record holders.

Sales of Unregistered Securities

During 2005, we issued and sold the following unregistered securities:

(a) On April 15, 2005, we issued and sold an aggregate of 1,600,000 shares of common stock to Steve Colmar, one of our directors at the time, Cliff Haigler, our Chief Financial Officer, Craig Colmar, Richard Rees, our Vice President of Business Development and Secretary and one of our directors at the time, and Austin Trust, at a price of $0.01 per share, for an aggregate of $16,000 in connection with our formation. In addition, on April 15, 2005, we issued and sold 300,000 shares of common stock to Business Ventures Corp., our bridge lender for expenses in connection with our initial public offering, at a price of $0.01 per share, for an aggregate of $3,000 of non-cash consideration. Steve Colmar is the trustee of Austin Trust and a shareholder of Business Ventures Corp. The foregoing purchases and sales were exempt from registration under the Securities Act pursuant to Section 4(2) thereof on the basis that the transaction did not involve a public offering.

(b) On August 26, 2005, we issued and sold (i) 200,000 shares of common stock to Mitchell Koulouris, our President and Chief Executive Officer and one of our directors, (ii) 200,000 shares of common stock to Anders Brown, our Chief Operating Officer, and (iii) 200,000 shares of common stock to Peter Koulouris, our Vice President of Business Development, at a price of $0.01 per share, for an aggregate of $6,000, in each instance paid for in cash and non-cash consideration. The foregoing purchases and sales were exempt

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from registration under the Securities Act pursuant to Section 4(2) thereof on the basis that the transaction did not involve a public offering.

(c) On August 30, 2005, we issued and sold 75,000 shares of common stock to Richard Rees, one of our directors at the time and our current Vice President of Business Development, at a price of $.01 per share, for an aggregate of $750, paid in non-cash consideration. The foregoing purchase and sale was exempt from registration under the Securities Act pursuant to Section 4(2) thereof on the basis that the transaction did not involve a public offering.

(d) On September 27, 2005, we issued and sold 100,000 shares of common stock to Clayton Trier, a director and our Chairman of the Board, at a price of $0.01 per share, for an aggregate of $1,000, paid in non-cash consideration. The foregoing purchase and sale was exempt from registration under the Securities Act pursuant to Section 4(2) thereof on the basis that the transaction did not involve a public offering.

The number of shares of common stock set forth above includes the effect of a 1,250 for 1 stock split in the form of a dividend as of September 8, 2005. Except as indicated above, none of the foregoing transactions involved any underwriters, underwriting discounts or commissions, or any public offering, and we believe that each transaction was exempt from the registration requirements of the Securities Act by virtue of Section 4(2) thereof. The recipients in such transactions acquired the securities for investment only and not with a view to or for sale in connection with any distribution thereof, and appropriate legends were affixed to the share certificates and instruments issued in such transactions. All recipients either received adequate information about us or had access, through their relationships with us, to such information.

Use of Proceeds of Initial Public Offering

We registered the initial public offering of our common stock, par value $0.01 per share, on a Registration Statement on Form S-1 (Registration No. 333-128687), which was declared effective on February 1, 2006. On February 7, 2006, we closed the initial public offering of our common stock by selling 3.9 million shares at $9.75 per share. The managing underwriters of the offering were I-Bankers Securities, Inc. and FTN Midwest Securities Corp. Gross proceeds from the offering were approximately $38.0 million. Total expenses from the offering were approximately $4.7 million, which included underwriting discounts and commissions and non-accountable expense allowance of approximately $3.0 million, and approximately $1.7 million in other offering-related expenses. Net offering proceeds, after deducting total expenses were approximately $33.3 million.

Dividend Policy

We have never declared or paid any cash dividends on our common stock. We currently intend to retain our future earnings, if any, for future growth and development of our business and do not anticipate paying any cash dividends in the foreseeable future. Any future determination to pay dividends will be at the discretion of our board or directors and will depend on our results of operations, financial conditions, contractual and legal restrictions and other factors the board deems relevant.

Equity Compensation Plans

The information required by this item regarding equity compensation plans is incorporated by reference under the section entitled Equity Compensation Plan Information contained in our Proxy Statement for our 2006 Annual Meeting of Stockholders.

Item 6. SELECTED HISTORICAL AND PRO FORMA COMBINED FINANCIAL DATA

Digital Music Group, Inc. was incorporated in April 2005 and had no operations through December 31, 2005 other than pursuing certain acquisitions and an initial public offering of its common stock as discussed

below. For more information, refer to the audited financial statements of Digital Music Group, Inc. appearing elsewhere in this Annual Report on Form 10-K.

We acquired Digital Musicworks International, Inc. and certain assets of Rio Bravo Entertainment LLC, doing business as Psychobaby, on February 7, 2006, concurrent with the closing of our initial public offering on this date. For financial statement presentation purposes, Digital Musicworks International, Inc. has been identified as the accounting acquiror, and its historical financial results are therefore considered to be the historical financial results of Digital Music Group, Inc. Accordingly, the selected historical statement of operations data for the period from February 26, 2004 (Digital Musicworks International, Inc. s inception) to December 31, 2004 and for the year ended December 31, 2005, and the selected historical balance sheet data as of December 31, 2004 and 2005 have been derived from the audited financial statements of Digital Musicworks International, Inc., including the notes thereto, included elsewhere in this Annual Report on Form 10-K. The selected pro forma combined statement of operations data assumes that the merger between Digital Music Group, Inc. and Digital Musicworks International, Inc. and the acquisition of certain assets of Rio Bravo Entertainment LLC was completed as of the first day of each of the periods presented, whereas the selected pro forma combined balance sheet data assumes that they were completed on the date presented. The Pro Forma Adjusted for Offering column of selected balance sheet data further assumes the completion of our initial public offering as of December 31, 2005. The selected pro forma combined statement of operations and balance sheet data have been derived from the audited financial statements of Digital Musicworks International, Inc., and Digital Music Group, Inc., including the notes thereto, included elsewhere in this Annual Report on Form 10-K, and the unaudited financial statements of Rio Bravo Entertainment LLC, which have been prepared on the same basis as the audited financial statements and, in the opinion of management, reflect all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of such data. There were no transactions within the combined group. Accordingly, no amounts were required to be eliminated in the combination.

The historical results are not necessarily indicative of results to be expected for any future period. They should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and are qualified by reference to the audited financial statements and related notes of Digital Musicworks International, Inc. appearing elsewhere in this Annual Report on Form 10-K. In addition, the adjustments used in the preparation of the pro forma combined statements are based on estimates, available information and certain assumptions which may be revised as additional information becomes available. The pro forma financial data do not purport to represent what our combined results of operations would actually have been if the acquisitions referred to above had in fact occurred at the beginning of the periods presented, and are not necessarily representative of our results of operations for any future period since the companies were not under common management or control during the periods presented.

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	Historical		Pro Forma	
	Period From February 26, 2004 (Inception) to December 31, 2004	For the Year Ended December 31, 2005	Period From February 26, 2004 (Inception) to December 31, 2004	For the Year Ended December 31, 2005
Statement of Operations Data:				
Revenue	$ 37,268	$ 679,975	$ 73,020	$ 1,056,241
Cost of revenue:				
Royalties and payments to content owners	10,703	232,294	40,004	523,229
Amortization of digital music rights	3,041	22,518	124,916	144,393
Write-down of non-productive assets		295,356		295,356
Gross profit (loss)	23,524	129,807	(91,900)	93,263
Operating expenses	666,831	1,550,424	673,895	1,637,620
Interest, taxes and other expense, net	1,291	136,997	1,291	147,330
Net loss	$ (644,598)	$ (1,557,614)	$ (767,086)	$ (1,691,687)
Net loss per share basic and fully diluted(1)	$ (.29)	$ (.69)	$ (.16)	$ (.36)
Shares outstanding basic and fully diluted(1)	2,250,000	2,250,000	4,700,000	4,700,000
Operating Data:				
Number of tracks for sale at end of period	700	30,600	1,600	36,400
Number of paid downloads during the period	59,800	973,300	134,100	1,601,500

(1) As Digital Musicworks International, Inc. has been identified as the accounting acquiror, shares used in the calculation of historical net loss per share represent the number of shares of Digital Music Group, Inc. exchanged in connection with its merger with Digital Musicworks International, Inc. Shares used in the calculation of the pro forma net loss per share represent shares of Digital Music Group, Inc. and include (i) a total of 2,275,000 shares of common stock issued by Digital Music Group, Inc. in connection with the merger with Digital Musicworks International, Inc. and the acquisition of certain assets of Rio Bravo Entertainment LLC, and (ii) 2,425,000 shares of common stock issued by Digital Music Group, Inc. to its founding stockholders and certain of its management personnel.

	Historical December 31,		Pro Forma December 31,		Pro Forma Adjusted for Offering December 31,
	2004	2005	2004	2005	2005
Balance Sheet Data:					
Cash and cash equivalents	$ 735,837	$ 468,490	$ 760,837	$ 471,168	$ 33,754,168
Working capital (deficit)	657,121	556,982	682,121	(166,569)	33,781,344
Total assets	1,206,280	3,017,619	1,353,155	3,928,960	36,547,047
Capital lease obligations	88,553	44,540	88,553	44,540	44,540
Stockholders equity	1,033,658	2,417,256	1,180,533	2,602,368	35,885,368

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Item 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with the audited financial statements and related notes of Digital Music Group, Inc. and Digital Musicworks International, Inc. appearing elsewhere in this Annual Report on Form 10-K. This discussion contains forward-looking statements, the accuracy of which involves risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements for many reasons, including the risks faced by us described in Risk Factors.

Overview

Background and Basis of Presentation

Digital Music Group, Inc. was organized as a Delaware corporation in April 2005 to become a leading owner of digital rights to music and other sound recordings and distributor of these recordings to online music stores. In September 2005, we entered into a merger agreement to acquire Digital Musicworks International, Inc. and an asset purchase agreement to acquire certain assets of Rio Bravo Entertainment LLC, doing business as Psychobaby. The assets of Rio Bravo Entertainment LLC to be acquired consist solely of agreements for digital distribution rights to music recordings and its agreements with online music stores. Both of these acquisitions were completed concurrently with the closing of our initial public offering on February 7, 2006.

Digital Music Group, Inc. does not have an operating history separate from the operations of Digital Musicworks International, Inc. and the digital music distribution operations of Rio Bravo Entertainment LLC. In addition, as Digital Musicworks International, Inc. has been identified in these transactions as the acquiror for accounting purposes, its historical financial results are therefore considered to be the historical financial results of Digital Music Group, Inc. This discussion consists of an analysis of the key trends and seasonality, critical accounting policies and estimates, recent accounting pronouncements and other factors affecting us, followed by a specific discussion of the business, results of operations, factors affecting future results, and liquidity and capital resources of Digital Musicworks International, Inc., which is the accounting acquiror.

Key Trends Affecting Demand for Digital Music Recordings

We believe that the recorded music industry is presently undergoing a significant change, with the primary means of music distribution transitioning from physical formats (compact discs) to digital formats accessed over the Internet and wireless and cable networks. We believe this is a direct result of the popularity and proliferation of personal computers and portable digital music players like the Apple iPod, and consumer acceptance and the music industry s endorsement of legitimate digital music sales. We believe this transition is just beginning and the market share of digital music will increase and digital formats will ultimately become the preferred way consumers purchase and listen to music.

Seasonality

The early-stage nature of the entire digital music industry and our limited operating history have not allowed us to identify seasonality in our business, although we suspect that the fourth quarter of the calendar year may have seasonally higher sales for digital music, just as it is the highest quarter for sales of recorded music in physical format.

Critical Accounting Policies and Estimates

The financial statements of Digital Music Group, Inc. and Digital Musicworks International, Inc. presented in this Annual Report on Form 10-K were prepared in accordance with accounting principles generally accepted in the United States of America. In preparing these financial statements, it was necessary for us to make

estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. On an ongoing basis, we will evaluate our estimates and judgments, including those related to customer revenue, accounts receivable, capitalized digital music rights, advance royalties, income taxes, contingencies and litigation. We base our estimates and judgments on our experience and on various other factors that we believe to be 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. We believe the following critical accounting policies, among others, affect our more significant judgments and estimates used in the preparation of our financial statements.

Revenue Recognition and Accounts Receivable

We derive our revenue from leading online music stores that sell to consumers the digital music recordings that we have acquired or control through licenses with record labels, artists, publishers or other content owners. We receive revenue from online music stores that charge consumers on a per download basis for each download of a music recording. In addition, we receive revenue from subscription-based online music stores calculated as a percentage of the subscription price paid by the consumer based on the percentage of times our digital music recordings are listened to or downloaded as compared to the total for all available music recordings during the relevant time period. Our revenue is directly related to the number of times our digital music recordings are listened to or downloaded from the online music stores. Each online music store provides detailed reports of our revenue, generally on a monthly basis within 30 days following the end of the month, pursuant to the terms of our agreement with such online music store, and we recognize revenue in the month the transaction occurs. We receive payment at approximately the same time as we receive these reports of download activity. Our accounts receivable therefore consists of approximately one month s revenue. We have never experienced a bad debt and have never recorded a bad debt allowance.

Acquisition Costs for Digital Music Rights

We capitalize the costs of acquiring or licensing the digital rights to music recordings, which are amortized using the straight-line method over the shorter of the term of the related agreement or seven years, which we believe reasonably relates the amount of amortization to the revenue expected to be generated. Legitimate music downloading through online music stores has only recently become available. Accordingly, we have limited data upon which to base amortization assumptions. Because our music recordings are primarily past hits, live performances, previously unreleased studio tracks and other vintage recordings, primarily from the 1950s through the 1970s, spanning a broad array of genres and artists, they are not subject to initial high demand and subsequent drop-off in sales typically experienced by new releases of current mainstream music. Our limited experience has shown that download activity in our music recordings generally tends to be steady from month-to-month. As a result, we believe that our amortization method and term are reasonable in the circumstances. Management will continue to monitor download trends of our music and may adjust amortization methodology, periods and resulting rates in the future if the number of downloads and resulting cash flow trends are substantially different than anticipated. This could result from changes in consumer demand for our library of music recordings or general industry conditions. The impact of any such change would be insignificant to historically reported financial information contained in this Annual Report on Form 10-K, but could have a material effect in the future as we seek to expand our music library and are likely to spend increasing amounts to acquire additional digital music rights.

Royalty Advances

Royalty advances are cash amounts paid to content owners in connection with our contractual agreements for the right to sell digital music recordings for a specific period of time, usually seven to ten years. These advances are recorded as prepaid assets. On a monthly basis, as each online music store reports the number of

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downloads of each music recording and pays to us the gross revenue attributable to such downloads, the portion of such revenue due to each content owner under our long-term license agreement is charged to cost of revenue and the royalty advance account is reduced until it is fully recouped.

Valuation of Capitalized Digital Music Rights and Royalty Advances

Total capitalized digital music rights and royalty advances amounted to approximately $2.0 million as of December 31, 2005. In addition, we have future obligations of approximately $1.3 million related to long-term license agreements which are not yet reflected in the capitalized amounts as the related master recordings have not yet been delivered to us pursuant to such agreements. We periodically, but at least on an annual basis, review these assets for evidence of impairment by comparing the expected future cash flows to be generated from these assets to the carrying value of the assets and the future obligations. Future adverse changes in market conditions or poor demand for our music recording assets could result in losses or an inability to recover the carrying value of the asset, thereby possibly requiring an impairment charge in the future. During 2005, we recorded a write-down of approximately $295,000 pertaining to certain contracts with recording artists as more fully discussed in Note 1 to the financial statements of Digital Musicworks International, Inc.

Share-Based Compensation

We elected early adoption of Statement No. 123 (revised 2004) of the Financial Accounting Standards Board. See Recent Accounting Pronouncements below. As a result, we recognize compensation expense in an amount equal to the estimated fair value of share-based awards and issuances, such as stock options and warrants granted to employees and non-employees. Such expense is recognized over the period during which the recipient is required to provide services in exchange for the award or issuance (usually the vesting period). The computation of share-based compensation cost involves numerous assumptions by management. We utilize the fair value method, whereby the compensatory element of each share-based grant or issuance is estimated on the date of grant using the Black-Scholes fair value model. Assumptions used in this model include, among others, expected life (turnover), risk-free interest rate, dividend yield and volatility of the underlying equity security. In addition, as a private company prior to this offering, the fair market value of the underlying equity security at date of grant was determined by the board of directors after considering information available to the directors at that time, as opposed to an independent market valuation. The use of different assumptions by management in the Black-Scholes model can produce substantially different results. During 2005, the total share-based compensation cost recognized by us on a pro forma combined basis was approximately $35,000. However, that amount will increase significantly and reduce reported results of operations in the future to the extent that share-based awards and issuances are being made to newly-elected independent directors and to management and employees under our Amended and Restated 2005 Stock Plan.

Accounting for Income Taxes

Deferred income taxes result primarily from temporary differences between financial and tax reporting. Deferred tax assets and liabilities are determined based on the difference between the financial statement basis and tax basis of assets and liabilities using enacted tax rates. Future tax benefits are subject to a valuation allowance when management is unable to conclude that its deferred tax assets will more likely than not be realized from the results of operation. At December 31, 2004 and December 31, 2005, because of its limited operating history and net losses recorded since inception, Digital Musicworks International, Inc. recorded a full valuation allowance against deferred income taxes.

The federal and state unused net operating loss carryforward generated by Digital Musicworks International, Inc. since its inception in 2004 will begin to expire in 2019 and 2014, respectively. In addition to potential expiration, there are several factors that could limit or eliminate our ability to use these federal and state tax loss carryforwards. For example, under section 382 of the Internal Revenue Code of 1986, as amended, use of prior net operating loss carryforwards is limited after an ownership change. Digital Musicworks International, Inc.

may be subject to limitations on the use of its net operating loss carryforwards as provided under section 382 because of prior or future sales of securities. Accordingly, it is not certain how much of the existing net operating loss carryforwards will be available for our use. If we generate taxable income in the future, which may not happen, the use of net operating loss carryforwards that have not expired would have the effect of reducing our tax liability and increasing our net income and available cash resources in the future.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Compensation* (SFAS No. 123R). SFAS No. 123R requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost is to be measured based on the fair value of the equity or liability instruments issued. SFAS No. 123R covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights and employee share purchase plans. SFAS No. 123R replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*. We chose early adoption of SFAS No. 123R in 2004.

Results of Operations

For financial statement presentation purposes, Digital Musicworks International, Inc. has been identified as our accounting acquiror. The following table sets forth selected statement of operations data and such data as a percentage of revenues for Digital Musicworks International, Inc. for the periods presented:

	Period from February 26, 2004 (Inception) to December 31, 2004		For the Year Ended December 31, 2005	
	Amount	Percentage of Total	Amount	Percentage of Total
Revenue	$ 37,268	100.0%	$ 679,975	100.0%
Cost of revenue:				
Royalties and payments to content owners	10,703	28.7	232,294	34.2
Amortization of digital music rights	3,041	8.2	22,518	3.3
Write-down of non-productive assets			295,356	43.4
Gross profit	23,524	63.1	129,807	19.1
Operating expenses	666,831	1,689.3	1,550,424	128.0
Interest, taxes and other expense, net	1,291	3.5	136,997	20.1
Net loss	$ (644,598)	(1,629.6)%	$ (1,557,614)	(129.1)%

Digital Musicworks International, Inc. s revenue is derived primarily from online music stores that offer its music recordings on a pay-per-download or subscription basis. The company s digital rights to these music recordings are held through a combination of purchase agreements, long-term license agreements and short-term distribution agreements. Apple iTunes, the most popular online music store, accounted for approximately 93% and 87% of its revenue during the period from inception to December 31, 2004 and the year ended December 31, 2005, respectively. The amount paid to Digital Musicworks International, Inc. per download is negotiated in advance at the time it enters into an agreement with an online music store. Although the company negotiates with each store separately, its experience is that the percentage of the retail price paid to rights holders does not vary significantly across music stores.

Cost of revenue consists of (i) royalties to artists and publishers, (ii) revenue sharing payments based on long-term license or short-term distribution agreements with content owners, (iii) amortization of costs to acquire

digital rights to music recordings, and (iv) reserves or write-downs in capitalized digital music rights or advances that may be deemed necessary from time-to-time. Digital Musicworks International, Inc. purchases or licenses the digital rights to previously recorded music and has no influence over the terms as stipulated in the original recording contract between the content owner and artists or publishers. The company s experience is that these artist royalty obligations have historically been between 0% and 15% of the revenue attributable to a specific track or album. The publisher royalties are a statutory rate in the United States of America, which was $0.085 per music recording sold during 2005, increasing to $0.091 in January 2006. As part of the company s negotiations to acquire the digital rights to music recordings, the content owner from whom it licenses the recordings will often pay certain or all of these artist and publisher royalties. Digital Musicworks International, Inc. also enters into long-term license agreements with content owners that also typically include a revenue sharing arrangement whereby the content owner receives 25% to 50% of the revenue earned (after certain deductions) over the term of the agreement. In most cases, as an inducement to enter into the long-term license agreement, Digital Musicworks International, Inc. will make a royalty advance against the content owner s share of future royalties under this revenue sharing arrangement. All such advance royalties are capitalized as a prepaid asset that is expensed as cost of revenue as the related revenue is earned and the cash advances are recouped. In short-term distribution agreements, Digital Musicworks International, Inc. is not responsible for any artists or publishers royalties and makes no upfront or fixed payments to the content owner at the time it enters into the agreement. Therefore, the revenue sharing percentage retained by the content owner (generally 80% to 85%) is substantially higher than under long-term license agreements. Digital Musicworks International, Inc. also capitalizes the acquisition costs of its perpetual and long-term digital rights and amortizes these amounts over the shorter of seven years or the length of the contract, which it believes reasonably relates the amount of amortization to the revenue expected to be generated.

Operating expenses include all direct and indirect selling, general and administrative costs associated with processing music recordings and operating the business. Digital Musicworks International, Inc. has incurred losses since its inception. As of December 31, 2005, these losses totaled approximately $2.2 million. Although we expect an increase in future revenue, we are likely to continue to incur losses during 2006 as a result of higher operating expenses. These increased operating expenses will be caused primarily by adding personnel dedicated to business development, accounting and operations and for other reasons described below under Factors Affecting Future Results.

Comparison of Period from February 26, 2004 (Inception) to December 31, 2004 and the year ended December 31, 2005

Revenue. Revenue grew from $37,268 for the period from February 26, 2004 (inception) to December 31, 2004, to $679,975 for the year ended December 31, 2005. From inception to December 31, 2004, Digital Musicworks International, Inc. s revenue was insignificant because it was beginning its operations and focused on acquiring its initial digital rights to music recordings, establishing relationships with online music stores and identifying artists to sign to its record label. Digital Musicworks International, Inc. had only approximately 700 music recordings available for purchase as of December 31, 2004, compared to 30,600 available for purchase at online music stores as of December 31, 2005. The increase in music recordings available for purchase and corresponding number of downloads were the driving factor behind the increase in revenues.

Cost of revenue. Cost of revenue increased from $13,744, or 36.9% of revenue, for the period from February 26, 2004 (inception) to December 31, 2004, to $550,168, or 80.9% of revenue, for the year ended December 31, 2005. The cost of revenue for the year ended December 31, 2005 was negatively impacted by the write-down of non-productive assets of $295,356, relating to cash advances and the capitalized costs of producing master recordings under contracts with certain recording artists. During 2005, Digital Musicworks International, Inc. cancelled certain of these contracts and does not believe that future cash flows will be sufficient to recover the advances and costs that were capitalized under the remainder of the contracts. We are no longer seeking to sign additional artists as a means of furthering our digital music strategy. Excluding the write-down amount of $295,356, cost of revenue would have been $254,812, or 37.5% of revenue, for the year ended December 31, 2005.

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Operating expenses. The following table sets forth the individual components of operating expenses for the period from February 26, 2004 (inception) to December 31, 2004 and for the year ended December 31, 2005:

	Period from February 26, 2004 (Inception) to December 31, 2004		For the Year Ended December 31, 2005	
	Amount	Percentage of Total	Amount	Percentage of Total
Personnel-related expenses	$ 320,959	48.1%	$ 836,768	54.0%
Professional fees	180,405	27.1	265,473	17.1
Travel-related expenses	56,758	8.5	117,957	7.6
Other	108,709	16.3	330,226	21.3
Total	$ 666,831	100.0%	$ 1,550,424	100.0%

Operating expenses increased from $666,831 for the period from February 26, 2004 (inception) to December 31, 2004, to $1,550,424 for the year ended December 31, 2005. Operating expenses increased in 2005 because of a substantial increase in employees and resulting payroll costs, professional fees, travel related costs and other expenses as Digital Musicworks International, Inc. began to more aggressively identify and acquire rights to music recordings and process an increasing number of tracks for sale. We expect our operating expenses to increase substantially as we expand business development, operations and accounting activities over the next twelve months.

Interest, taxes and other expense, net. Interest, taxes and other expense increased from $1,291 for the period from February 26, 2004 (inception) to December 31, 2004, to $136,997 for the year ended December 31, 2005. In September 2005, in connection with the issuance of Digital Musicworks International, Inc. s Series B convertible preferred stock, $230,000 of subordinated convertible notes issued in June 2005 were converted into Series B shares at a discount to the note-holders, and this discount of $125,034 was charged to interest expense.

Selected Quarterly Results of Operations

The following table sets forth unaudited quarterly statement of operations data for each of the eight quarters through December 31, 2005:

	For the Quarters Ended (unaudited)							
	3/31/04(1)	6/30/04	9/30/04	12/31/04	3/31/05	6/30/05	9/30/05	12/31/05
Statement of Operations Data:								
Revenue	$	$ 852	$ 10,851	$ 25,565	$ 41,480	$ 53,560	$ 130,495	$ 454,440
Cost of revenue:								
Royalties and payments to content owners		567	2,914	7,222	14,411	18,485	36,078	163,320
Amortization of digital music rights			211	2,830	3,923	5,065	6,061	7,469
Write-down of non-productive assets						73,442		221,914
Gross profit (loss)		285	7,726	15,513	23,146	(43,432)(2)	88,356	61,737(3)
Operating expenses	64	8,629	207,735	450,403	537,745	333,782	257,050	421,847
Interest, taxes and other expense, net		(800)	381	(872)	1,495	(7,056)		
Proceeds from sales	0	75,074						
Proceeds from maturities and redemptions	410,909	358,875						
Purchases	(395,337)	(489,963)						
Proceeds from the redemption of FHLB stock	7,317	6,969						
Proceeds from bank owned life insurance	2,071	88						
Proceeds from sale of loans	15,981	5,763						

Proceeds from sales of other assets	15,301	7,037
Net (increase) decrease in loans	(185,018)	184,440
Purchases of premises and equipment	(6,468)	(6,542)
Net cash (used in) provided by investing activities	(135,244)	141,741
Financing Activities		
Net decrease in federal funds purchased	(54,800)	(800)
Net increase (decrease) in other short-term borrowings	203,792	(13,281)
Net decrease in deposits	(10,206)	(132,912)
Repayments of other long-term debt	(25,358)	(24,444)
Proceeds from issuance of common stock	0	144
Discount on dividend reinvestment plan purchases	(67)	(48)
Dividends paid	(13,633)	(9,418)
Proceeds from reissuance of treasury stock	617	72
Purchase of treasury stock	(9,112)	(9)
Stock option tax benefit	1	0
Net cash provided by (used in) financing activities	91,234	(180,696)
Net increase in cash and cash equivalents	10,586	19,988
Cash and cash equivalents at January 1	78,478	69,858
Cash and cash equivalents at September 30	$ 89,064	$ 89,846

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data*

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Basis of Presentation

The accounting and reporting policies of First Commonwealth Financial Corporation and its subsidiaries (First Commonwealth or Company) conform with generally accepted accounting principles in the United States of America (GAAP). The preparation of financial statements in conformity with GAAP requires management to make estimates, assumptions and judgments that affect the amounts reported in the financial statements and accompanying notes. Actual realized amounts could differ from those estimates. In the opinion of management, the unaudited interim condensed consolidated financial statements include all adjustments (consisting of only normal recurring adjustments) necessary for a fair presentation of First Commonwealth s financial position, results of operations, cash flows and changes in shareholders equity as of and for the periods presented.

The results of operations for the nine-months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the full year of 2012. These interim financial statements should be read in conjunction with First Commonwealth s 2011 Annual Report on Form 10-K which is available on First Commonwealth s website at http://www.fcbanking.com.

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and interest-bearing bank deposits. Generally, federal funds are sold for one-day periods.

Note 2 Supplemental Comprehensive Income Disclosures

The following table identifies the related tax effects allocated to each component of other comprehensive income (OCI) in the Condensed Consolidated Statements of Comprehensive Income:

	For the Nine-Months Ended September 30,					
	2012			2011		
	Pretax Amount	Tax (Expense) Benefit	Net of Tax Amount	Pretax Amount	Tax (Expense) Benefit	Net of Tax Amount
	(dollars in thousands)					
Unrealized gains on securities:						
Unrealized holding gains on securities arising during the period	$ 3,165	$ (1,100)	$ 2,065	$ 12,205	$ (4,272)	$ 7,933
Non-credit related gains (losses) on securities not expected to be sold	1,549	(542)	1,007	(218)	76	(142)
Reclassification adjustment for gains on securities included in net income	(163)	57	(106)	(2,185)	765	(1,420)
Total other comprehensive income	$ 4,551	$ (1,585)	$ 2,966	$ 9,802	$ (3,431)	$ 6,371

	For the Three-Months Ended September 30,					
	2012			2011		
	Pretax Amount	Tax (Expense) Benefit	Net of Tax Amount	Pretax Amount	Tax (Expense) Benefit	Net of Tax Amount
	(dollars in thousands)					
Unrealized gains on securities:						
Unrealized holding gains on securities arising during the period	$ 2,068	$ (722)	$ 1,346	$ 4,696	$ (1,644)	$ 3,052
Non-credit related gains (losses) on securities not expected to be sold	1,374	(481)	893	(2,535)	887	(1,648)
	(163)	57	(106)	0	0	0

Reclassification adjustment for gains on securities included in net income						
Total other comprehensive income	$ 3,279	$ (1,146)	$ 2,133	$ 2,161	$ (757)	$ 1,404

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 3 Supplemental Cash Flow Disclosures

The following table presents information related to cash paid during the period for interest and income taxes as well as detail on non-cash investing and financing activities for the nine-months ended September 30:

	2012	2011
	(dollars in thousands)	
Cash paid during the period for:		
Interest	$ 25,685	$ 34,904
Income taxes	8,900	4,400
Non-cash investing and financing activities:		
ESOP loan reductions	$ 1,500	$ 1,500
Loans transferred to other real estate owned and repossessed assets	4,053	25,883
Other real estate owned sold and settled out of period	80	7,260
Loans transferred from held to maturity to available for sale	0	823
Gross increase in market value adjustment to securities available for sale	4,529	9,792

Note 4 Earnings per Share

The following table summarizes the composition of the weighted-average common shares (denominator) used in the basic and diluted earnings per share computations:

	For the Three-Months Ended September 30,		For the Nine-Months Ended September 30,	
	2012	2011	2012	2011
Weighted average common shares issued	105,563,455	105,563,455	105,563,455	105,545,880
Average treasury shares	(1,258,029)	(656,461)	(738,769)	(658,944)
Averaged unearned ESOP shares	(17,575)	(148,871)	(50,790)	(181,633)
Average unearned nonvested shares	(207,826)	(29,208)	(180,771)	(27,070)
Weighted average common shares and common stock equivalents used to calculate basic earnings per share	104,080,025	104,728,915	104,593,125	104,678,233
Additional common stock equivalents (nonvested stock) used to calculate diluted earnings per share	16,874	0	2,224	0
Additional common stock equivalents (stock options) used to calculate diluted earnings per share	1,484	0	47	203
Weighted average common shares and common stock equivalents used to calculate diluted earnings per share	104,098,383	104,728,915	104,595,396	104,678,436

The following table shows the number of shares and the price per share related to common stock equivalents that were not included in the computation of diluted earnings per share for the nine-months ended September 30, because to do so would have been antidilutive.

	2012			2011		
		Price Range			Price Range	
	Shares	From	To	Shares	From	To
Stock Options	293,777	$ 6.90	$ 14.55	513,210	$ 6.36	$ 14.55
Restricted Stock	93,565	5.96	6.82	20,101	5.70	6.82

FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 5 Variable Interest Entities

As defined by Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 810-10, a Variable Interest Entity (VIE) is a corporation, partnership, trust or any other legal structure used for business purposes that either (a) does not have equity investors with voting rights or (b) has equity investors that do not provide sufficient financial resources for the entity to support its activities. Under ASC 810-10, an entity that holds a variable interest in a VIE is required to consolidate the VIE if the entity is deemed to be the primary beneficiary, which generally means it is subject to a majority of the risk of loss from the VIE s activities, is entitled to receive a majority of the entity s residual returns, or both.

First Commonwealth s VIEs are evaluated under the guidance included in FASB Accounting Standards Update (ASU) 2009-17. These VIEs include qualified affordable housing projects that First Commonwealth has invested in as part of its community reinvestment initiatives. We periodically assess whether or not our variable interests in the VIE, based on qualitative analysis, provide us with a controlling interest in the VIE. The analysis includes an assessment of the characteristics of the VIE. We do not have a controlling financial interest in the VIE, which would require consolidation of the VIE, as we do not have the following characteristics: (1) the power to direct the activities that most significantly impact the VIE s economic performance; and (2) the obligation to absorb losses or the right to receive benefits from the VIE that could potentially be significant to the VIE.

First Commonwealth s maximum potential exposure is equal to its carrying value and is summarized in the table below:

	September 30, 2012	December 31, 2011
	(dollars in thousands)	
Low Income Housing Limited Partnership Investments	$ 465	$ 667

Note 6 Commitments and Contingent Liabilities

Commitments and letters of credit

Standby letters of credit and commercial letters of credit are conditional commitments issued by First Commonwealth to guarantee the performance of a customer to a third party. The contract or notional amount of these instruments reflects the maximum amount of future payments that First Commonwealth could be required to pay under the guarantees if there were a total default by the guaranteed parties, without consideration of possible recoveries under recourse provisions or from collateral held or pledged. In addition, many of these commitments are expected to expire without being drawn upon; therefore, the total commitment amounts do not necessarily represent future cash requirements.

The following table identifies the notional amount of those instruments at:

	September 30, 2012	December 31, 2011
	(dollars in thousands)	
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	$ 1,515,221	$ 1,495,009
Financial standby letters of credit	48,864	53,689
Performance standby letters of credit	77,795	76,371
Commercial letters of credit	1,047	1,297

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 6 Commitments and Contingent Liabilities (Continued)

Commitments and letters of credit (Continued)

The current notional amounts outstanding as of September 30, 2012 include financial standby letters of credit of $0.3 million, performance standby letters of credit of $19.5 million, and commercial letters of credit $0.4 million issued during the first nine months of 2012. A liability of $0.2 million and $0.1 million has been recorded as of September 30, 2012 and December 31, 2011, respectively, which represents the estimated fair value of letters of credit issued. The fair value of letters of credit is estimated based on the unrecognized portion of fees received at the time the commitment was issued.

Unused commitments and letters of credit provide exposure to future credit loss in the event of nonperformance by the borrower or guaranteed parties. Management s evaluation of the credit risk in these commitments resulted in the recording of a liability of $2.1 million as of September 30, 2012 and $1.5 million as of December 31, 2011. The credit risk evaluation incorporated probability of default, loss given default and estimated utilization for the next twelve months for each loan category and the letters of credit.

Legal proceedings

McGrogan v. First Commonwealth Bank is a class action that was filed on January 12, 2009, in the Court of Common Pleas of Allegheny County, Pennsylvania. The action alleges that First Commonwealth Bank (the Bank) promised class members a minimum interest rate of 8% on its IRA Market Rate Savings Account for as long as the class members kept their money on deposit in the IRA account. The class asserts that the Bank committed fraud, breached its modified contract with the class members, and violated the Pennsylvania Unfair Trade Practice and Consumer Protection Law when it resigned as custodian of the IRA Market Rate Savings Accounts in 2008 and offered the class members a roll-over IRA account with a 3.5% interest rate. At that time, there were 237 account holders with an average age of 64, and the aggregate balances in the IRA Market Rate Savings accounts totaled approximately $11.5 million. Plaintiffs seek monetary damages for the alleged breach of contract, punitive damages for the alleged fraud and Unfair Trade Practice and Consumer Protection Law violations and attorney s fees. On July 27, 2011, the court granted class certification as to the breach of modified contract claim and denied class certification as to the fraud and Pennsylvania Unfair Trade Practice and Consumer Protection Law claims. The breach of contract claim is predicated upon a letter sent to customers in 1998 which reversed an earlier decision by the Bank to reduce the rate paid on the accounts. The letter stated, in relevant part, This letter will serve as notification that a decision has been made to re-establish the rate on your account to eight percent (8%). This rate will be retroactive to your most recent maturity date and will continue going forward on deposits presently in the account and on annual additions. On August 30, 2012, the Court entered an order granting the Bank s motion for summary judgment and dismissing the class action claims. The Court found that the Bank retained the right to resign as custodian of the accounts and that the act of resigning as custodian and closing the accounts did not breach the terms of the underlying IRA contract. The Plaintiffs have filed an appeal with the Pennsylvania Superior Court.

Other matters

There are no other material legal proceedings to which First Commonwealth or its subsidiaries are a party, or of which their property is the subject, except proceedings which arise in the normal course of business and, in the opinion of management, will not have a material adverse effect on the consolidated operations or financial position of First Commonwealth or its subsidiaries.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 7 Investment Securities

Below is an analysis of the amortized cost and estimated fair values of securities available for sale at:

	September 30, 2012				December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(dollars in thousands)							
Obligations of U.S. Government Agencies:								
Mortgage-Backed Securities Residential	$ 29,214	$ 4,141	$ 0	$ 33,355	$ 32,139	$ 4,061	$ (6)	$ 36,194
Obligations of U.S. Government-Sponsored Enterprises:								
Mortgage-Backed Securities Residential	786,945	31,333	0	818,278	771,196	29,835	0	801,031
Mortgage-Backed Securities Commercial	164	2	0	166	193	1	(1)	193
Other Government-Sponsored Enterprises	241,996	887	(2)	242,881	267,807	973	(132)	268,648
Obligations of States and Political Subdivisions	82	5	0	87	444	15	0	459
Corporate Securities	10,771	373	0	11,144	11,811	162	(562)	11,411
Pooled Trust Preferred Collateralized Debt Obligations	52,696	2	(29,647)	23,051	54,762	3	(31,785)	22,980
Total Debt Securities	1,121,868	36,743	(29,649)	1,128,962	1,138,352	35,050	(32,486)	1,140,916
Equities	1,860	0	0	1,860	1,860	0	0	1,860
Total Securities Available for Sale	$ 1,123,728	$ 36,743	$ (29,649)	$ 1,130,822	$ 1,140,212	$ 35,050	$ (32,486)	$ 1,142,776

The amortized cost and estimated fair value of debt securities available for sale at September 30, 2012, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or repay obligations with or without call or prepayment penalties.

	Amortized Cost	Estimated Fair Value
	(dollars in thousands)	
Due within 1 year	$ 7,001	$ 7,007
Due after 1 but within 5 years	235,077	235,961
Due after 5 but within 10 years	0	0
Due after 10 years	63,467	34,195

	305,545	277,163
Mortgage-Backed Securities (a)	816,323	851,799
Total Debt Securities	$ 1,121,868	$ 1,128,962

(a) Mortgage Backed Securities include an amortized cost of $29.2 million and a fair value of $33.4 million for Obligations of U.S. Government agencies issued by Ginnie Mae and Obligations of U.S. Government-sponsored enterprises issued by Fannie Mae and Freddie Mac which had an amortized cost of $787.1 million and a fair value of $818.4 million.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 7 Investment Securities (Continued)

Proceeds from sale, gross gains (losses) realized on sales, maturities and other-than-temporary impairment charges related to securities available for sale were as follows for the nine-months ended September 30:

	2012	**2011**
	(dollars in thousands)	
Proceeds from sale	$ 0	$ 75,074
Gross gains (losses) realized:		
Sales Transactions:		
Gross gains	$ 0	$ 2,368
Gross losses	0	(258)
	0	2,110
Maturities and impairment		
Gross gains	163	75
Gross losses	0	0
Other-than-temporary impairment	0	0
	163	75
Net gains and impairment	$ 163	$ 2,185

Securities available for sale with a fair value of $599.6 million and $668.8 million were pledged as of September 30, 2012 and December 31, 2011, respectively, to secure public deposits and for other purposes required or permitted by law.

Note 8 Other Investments

As a member of the Federal Home Loan Bank (FHLB), First Commonwealth is required to purchase and hold stock in the FHLB to satisfy membership and borrowing requirements. This stock is restricted in that it can only be sold to the FHLB or to another member institution, and all sales of FHLB stock must be at par. As a result of these restrictions, FHLB stock is unlike other investment securities insofar as there is no trading market for FHLB stock and the transfer price is determined by FHLB membership rules and not by market participants. As of September 30, 2012 and December 31, 2011, our FHLB stock totaled $32.5 million and $39.8 million, respectively and is included in Other investments on the Condensed Consolidated Statements of Financial Condition.

During 2012 and 2011, the FHLB repurchased excess stock from its members by repurchasing the lessor of 5% of the members total capital stock outstanding or its total excess capital stock. As a result, during the nine-months ended September 30, 2012 and 2011, stock repurchases occurred in the amounts of $7.3 million and $7.0 million, respectively. The FHLB repurchased stock and paid dividends in each quarter of 2012, however, decisions regarding any future repurchase of excess capital stock and dividend payments will be made by the FHLB on a quarterly basis. Management reviewed the FHLB s Form 10-Q for the period ended June 30, 2012 filed with the SEC on August 8, 2012.

FHLB stock is held as a long-term investment and its value is determined based on the ultimate recoverability of the par value. First Commonwealth evaluates impairment quarterly. The decision of whether impairment exists is

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 8 Other Investments (Continued)

a matter of judgment that reflects our view of the FHLB s long-term performance, which includes factors such as the following:

its operating performance;

the severity and duration of declines in the fair value of its net assets related to its capital stock amount;

its commitment to make payments required by law or regulation and the level of such payments in relation to its operating performance;

the impact of legislative and regulatory changes on the FHLB, and accordingly, on the members of FHLB; and

its liquidity and funding position.

After evaluating all of these considerations, First Commonwealth concluded that the par value of its investment in FHLB stock will be recovered. Accordingly, no impairment charge was recorded on these securities for the nine-months ended September 30, 2012. Our evaluation of the factors described above in future periods could result in the recognition of impairment charges on FHLB stock.

Note 9 Impairment of Investment Securities

As required by FASB ASC Topic 320, Investments Debt and Equity Securities, credit related other-than-temporary impairment on debt securities is recognized in earnings while non-credit related other-than-temporary impairment on debt securities not expected to be sold is recognized in OCI. During the nine-months ended September 30, 2012 and 2011, no other-than-temporary impairment charges were recognized. For the nine-months ended September 30, 2012, $1.5 million in non-credit related gains on our trust preferred collateralized debt obligations that were determined to be impaired in previous periods was recorded in OCI. For the same period in 2011, $0.2 million in non-credit related losses for the same pool of securities was recorded in OCI. All of the securities for which other-than-temporary impairment was recorded were classified as available for sale securities.

First Commonwealth utilizes the specific identification method to determine the net gain or loss on debt securities and the average cost method to determine the net gain or loss on equity securities.

In the Condensed Consolidated Statements of Income, the Changes in fair value on impaired securities line represents the change in fair value of securities impaired in the current or previous periods. The change in fair value includes both non-credit and credit related gains or losses. Credit related losses occur when the entire amortized cost of the security will not be recovered. The Non-credit related (gains) losses on securities not expected to be sold (recognized in other comprehensive income) line represents the gains and losses on the securities resulting from factors other than credit. The non-credit related gain or loss is disclosed in the Condensed Consolidated Statements of Income and recognized through other comprehensive income. The Net impairment losses line represents the credit related losses recognized in total noninterest income for the related period.

We review our investment portfolio on a quarterly basis for indications of impairment. This review includes analyzing the length of time and the extent to which the fair value has been lower than the cost, the financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer and whether we are more likely than not to sell the security. We evaluate whether we are more likely

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 9 Impairment of Investment Securities (Continued)

than not to sell debt securities based upon our investment strategy for the particular type of security and our cash flow needs, liquidity position, capital adequacy, tax position and interest rate risk position. In addition, the risk of future other-than-temporary impairment may be influenced by additional bank failures, weakness in the U.S. economy, changes in real estate values and additional interest deferrals in our pooled trust preferred collateralized debt obligations. Our pooled trust preferred collateralized debt obligations are beneficial interests in securitized financial assets within the scope of FASB ASC Topic 325, Investments Other, and are therefore evaluated for other-than-temporary impairment using management s best estimate of future cash flows. If these estimated cash flows indicate that it is probable that an adverse change in cash flows has occurred, then other-than-temporary impairment would be recognized in accordance with FASB ASC Topic 320. There is a risk that First Commonwealth will record other-than-temporary impairment charges in the future. See Note 12, Fair Values of Assets and Liabilities, for additional information.

The following table presents the gross unrealized losses and estimated fair values at September 30, 2012 by investment category and time frame for which securities have been in a continuous unrealized loss position:

	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses
	(dollars in thousands)					
Obligations of U.S. Government Agencies:						
Mortgage-Backed Securities Residential	$ 0	$ 0	$ 14	$ 0 (a)	$ 14	$ 0
Obligations of U.S. Government- Sponsored Enterprises:						
Mortgage-Backed Securities Residential	26	0 (a)	0	0	26	0
Other Government-Sponsored Enterprises	2,398	(2)	0	0	2,398	(2)
Pooled Trust Preferred Collateralized Debt Obligations	0	0	22,996	(29,647)	22,996	(29,647)
Total Debt Securities	2,424	(2)	23,010	(29,647)	25,434	(29,649)
Equities	0	0	0	0	0	0
Total Securities Available for Sale	$ 2,424	$ (2)	$ 23,010	$ (29,647)	$ 25,434	$ (29,649)

(a) Gross unrealized losses related to these types of securities are less than $1 thousand.

At September 30, 2012, pooled trust preferred collateralized debt obligations accounted for almost all of the unrealized losses, while fixed income securities issued by U.S. Government-sponsored enterprises comprised less than one percent of total unrealized losses. There were no equity securities in an unrealized loss position at September 30, 2012.

As of September 30, 2012, our corporate securities had an amortized cost and an estimated fair value of $10.8 million and $11.1 million, respectively, and were comprised of single issue trust preferred securities issued primarily by money center and large regional banks. As of December 31, 2011, the same portion of the portfolio had an amortized cost of $11.8 million and an estimated fair value of $11.4 million. There were no corporate securities in an unrealized loss position as of September 30, 2012, while as of December 31, 2011, there were $0.6 million in unrealized losses related to these investments. When unrealized losses exist, management reviews each of the issuer s asset quality, earnings

trend and capital position, to determine whether issues in an unrealized

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 9 Impairment of Investment Securities (Continued)

loss position were other-than-temporarily impaired. All interest payments on the corporate securities are being made as contractually required.

The following table presents the gross unrealized losses and estimated fair values at December 31, 2011 by investment category and time frame for which securities have been in a continuous unrealized loss position:

	Less Than 12 Months		12 Months or More		Total	
	Estimated Fair Value	**Gross Unrealized Losses**	**Estimated Fair Value**	**Gross Unrealized Losses**	**Estimated Fair Value**	**Gross Unrealized Losses**
			(dollars in thousands)			
Obligations of U.S. Government Agencies:						
Mortgage-Backed Securities Residential	$ 1,086	$ (6)	$ 16	$ 0 (a)	$ 1,102	$ (6)
Obligations of U.S. Government- Sponsored Enterprises:						
Mortgage-Backed Securities Residential	25	0 (a)	0	0	25	0
Mortgage-Backed Securities Commercial	151	(1)	0	0	151	(1)
Other Government-Sponsored Enterprises	55,969	(132)	0	0	55,969	(132)
Corporate Securities	4,536	(562)	0	0	4,536	(562)
Pooled Trust Preferred Collateralized Debt Obligations	0	0	22,927	(31,785)	22,927	(31,785)
Total Securities Available for Sale	$ 61,767	$ (701)	$ 22,943	$ (31,785)	$ 84,710	$ (32,486)

(a) Gross unrealized losses related to these types of securities are less than $1 thousand.

As of September 30, 2012, the book value of our pooled trust preferred collateralized debt obligations totaled $52.7 million with an estimated fair value of $23.1 million, which includes securities comprised of 339 banks and other financial institutions. Two of our pooled securities are senior tranches and the remainders are mezzanine tranches, three of which have no senior class remaining in the issue. Two of the pooled issues, representing $2.9 million of the $52.7 million book value, remain above investment grade. At the time of initial issue, the subordinated tranches ranged in size from approximately 7% to 35% of the total principal amount of the respective securities and no more than 5% of any pooled security consisted of a security issued by any one institution. As of September 30, 2012, after taking into account management s best estimates of future interest deferrals and defaults, six of our securities had no excess subordination in the tranches we own and seven of our securities had excess subordination which ranged from 10% to 566% of the current performing collateral.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 9 Impairment of Investment Securities (Continued)

The following table provides information related to our pooled trust preferred collateralized debt obligations as of September 30, 2012:

Deal	Class	Book Value	Fair Value	Unrealized Gain (Loss)	Moody s/ Fitch Ratings	Number of Banks	Deferrals and Defaults as a % of Current Collateral	Excess Subordination as a % of Current Performing Collateral
		(dollars in thousands)						
Pre TSL I	Senior	$ 1,009	$ 993	$ (16)	Aa3/A	17	38.98%	213.61%
Pre TSL IV	Mezzanine	1,830	645	(1,185)	Caa2/CCC	6	27.07	95.96
Pre TSL V	Mezzanine	53	55	2	C/	3	100.00	0.00
Pre TSL VII	Mezzanine	4,114	3,419	(695)	Ca/C	17	45.50	0.00
Pre TSL VIII	Mezzanine	1,794	1,016	(778)	C/C	34	48.43	0.00
Pre TSL IX	Mezzanine	2,259	811	(1,448)	Ca/C	47	25.88	9.64
Pre TSL X	Mezzanine	1,447	1,118	(329)	Ca/C	51	38.24	0.00
Pre TSL XII	Mezzanine	5,516	2,696	(2,820)	Ca/C	73	34.04	0.00
Pre TSL XIII	Mezzanine	12,418	4,714	(7,704)	Ca/C	63	37.50	13.84
Pre TSL XIV	Mezzanine	13,069	4,570	(8,499)	Ca/C	61	40.08	32.10
MMCap I	Senior	1,898	1,841	(57)	A3/A	17	48.60	565.56
MMCap I	Mezzanine	849	455	(394)	Ca/C	17	48.60	14.50
MM Comm IX	Mezzanine	6,440	718	(5,722)	Ca/CC	30	39.29	0.00
Total		$ 52,696	$ 23,051	$ (29,645)				

Lack of liquidity in the market for trust preferred collateralized debt obligations, credit rating downgrades and market uncertainties related to the financial industry are factors contributing to the impairment on these securities.

On a quarterly basis we evaluate our debt securities for other-than-temporary impairment. During the nine-months ended September 30, 2012 and 2011, there were no credit related other-than-temporary impairment charges recognized on our pooled trust preferred collateralized debt obligations. When evaluating these investments we determine a credit related portion and a non-credit related portion of other-than-temporary impairment. The credit related portion is recognized in earnings and represents the difference between book value and the present value of future cash flows. The non-credit related portion is recognized in OCI and represents the difference between the fair value of the security and the amount of credit related impairment. A discounted cash flow analysis provides the best estimate of credit related other-than-temporary impairment for these securities.

Additional information related to the discounted cash flow analysis follows:

Our pooled trust preferred collateralized debt obligations are measured for other-than-temporary impairment within the scope of FASB ASC Topic 325 by determining whether it is probable that an adverse change in estimated cash flows has occurred. Determining whether there has been an adverse change in estimated cash flows from the cash flows previously projected involves comparing the present value of remaining cash flows previously projected against the present value of the cash flows estimated at September 30, 2012. We consider the discounted cash

flow analysis to be our primary evidence when determining whether credit related other-than-temporary impairment exists.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 9 Impairment of Investment Securities (Continued)

Results of a discounted cash flow test are significantly affected by other variables such as the estimate of future cash flows, credit worthiness of the underlying banks and determination of probability of default of the underlying collateral. The following provides additional information for each of these variables:

Estimate of Future Cash Flows Cash flows are constructed in an INTEX cash flow model which includes each deal s structural features. For collateral issued by financial institutions with over $15 billion in asset size, we consider the alternative cost of funding and if that rate is less than the current rate being paid, we incorporate a prepayment in our estimate of future cash flows. The prepayment rates used are 20% in years 2 and 3 and a 2% prepayment rate thereafter. The modeled cash flows are then used to estimate if all the scheduled principal and interest payments of our investments will be returned.

Credit Analysis A quarterly credit evaluation is performed for each of the 339 banks comprising the collateral across the various pooled trust preferred securities. Our credit evaluation considers all evidence available to us and includes the nature of the issuer s business, its years of operating history, corporate structure, loan composition, loan concentrations, deposit mix, asset growth rates, geographic footprint and local economic environment. Our analysis focuses on profitability, return on assets, shareholders equity, net interest margin, credit quality ratios, operating efficiency, capital adequacy and liquidity.

Probability of Default A probability of default is determined for each bank and is used to calculate the expected impact of future deferrals and defaults on our expected cash flows. Each bank in the collateral pool is assigned a probability of default for each year until maturity. Currently, any bank that is in default is assigned a 100% probability of default and a 0% projected recovery rate. All other banks in the pool are assigned a probability of default based on their unique credit characteristics and market indicators with a 10% projected recovery rate. For the majority of banks currently in deferral we assume the bank continues to defer and will eventually default and, therefore, a 100% probability of default is assigned. However, for some deferring collateral there is the possibility that they become current on interest or principal payments at some point in the future and in those cases a probability that the deferral will ultimately cure is assigned. The probability of default is updated quarterly. As of September 30, 2012, default probabilities for performing collateral ranged from 0.33% to 75%.

Our credit evaluation provides a basis for determining deferral and default probabilities for each underlying piece of collateral. Using the results of the credit evaluation, the next step of the process is to look at pricing of senior debt or credit default swaps for the issuer (or where such information is unavailable, for companies having similar credit profiles as the issuer). The pricing of these market indicators provides the information necessary to determine appropriate default probabilities for each bank.

In addition to the above factors, our evaluation of impairment also includes a stress test analysis which provides an estimate of excess subordination for each tranche. We stress the cash flows of each pool by increasing current default assumptions to the level of defaults which results in an adverse change in estimated cash flows. This stressed breakpoint is then used to calculate excess subordination levels for each pooled trust preferred security. The results of the stress test allows management to identify those pools that are at a greater risk for a future break in cash flows so that we can monitor banks in those pools more closely for potential deterioration of credit quality.

Our cash flow analysis as of September 30, 2012, indicates that no credit related other-than-temporary impairment has occurred on our pooled trust preferred securities during the nine-months ended September 30, 2012. Based upon the analysis performed by management, it is probable that six of our pooled trust preferred

FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 9 Impairment of Investment Securities (Continued)

securities will experience principal and interest shortfalls and therefore appropriate other-than-temporary charges were recorded in prior periods. These securities are identified in the table on page 17 with 0%   Excess Subordination as a Percentage of Current Performing Collateral.   For the remaining securities listed in that table, our analysis as of September 30, 2012 indicates it is probable that we will collect all contractual principal and interest payments.

During 2008, 2009 and 2010, other-than-temporary impairment charges were recognized on all of our pooled trust preferred securities, except for PreTSL I, PreTSL IV and MMCap I-Senior. Our cash flow analysis as of September 30, 2012, for all of these impaired securities indicates that it is now probable we will collect principal and interest in excess of what was estimated at the time other-than-temporary impairment charges were recorded. This change can be attributed to improvement in the underlying collateral for these securities and has resulted in our current book value being below the present value of estimated future principal and interest payments. The excess for each bond of the present value of future cash flows over our current book value ranges from 14% to 144% and will be recognized as an adjustment to yield over the remaining life of these securities. During the three- and nine-months ended September 30, 2012, $0.4 million and $0.9 million, respectively, of the excess was recognized as an adjustment to yield on these securities.

The following provides a cumulative roll forward of credit losses recognized in earnings for debt securities held and not intended to be sold:

	For the Three-Months Ended September 30,		**For the Nine-Months Ended September 30,**	
	2012	**2011**	**2012**	**2011**
	(dollars in thousands)			
Balance, beginning (a)	$ 44,230	$ 44,850	$ 44,736	$ 44,850
Credit losses on debt securities for which other-than-temporary impairment was not previously recognized	0	0	0	0
Additional credit losses on debt securities for which other-than-temporary impairment was previously recognized	0	0	0	0
Increases in cash flows expected to be collected, recognized over the remaining life of the security (b)	(436)	0	(942)	0
Balance, ending	$ 43,794	$ 44,850	$ 43,794	$ 44,850

(a) The beginning balance represents credit related losses included in other-than-temporary impairment charges recognized on debt securities in prior periods.

(b) Represents the increase in cash flows recognized in interest income during the period.

In the third quarter of 2012 and 2011, no other-than-temporary impairment charges were recorded on equity securities. On a quarterly basis, management evaluates equity securities for other-than-temporary impairment by reviewing the severity and duration of decline in estimated fair value, research reports, analysts   recommendations, credit rating changes, news stories, annual reports, regulatory filings, impact of interest rate changes and other relevant information. As of September 30, 2012 and 2011, there are no equity securities in an unrealized loss position.

FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 10 Loans and Allowance for Credit Losses

The following table provides outstanding balances related to each of our loan types:

	September 30, 2012	**December 31, 2011**
	(dollars in thousands)	
Commercial, financial, agricultural and other	$ 1,087,019	$ 996,739
Real estate construction	95,425	76,564
Residential real estate	1,228,328	1,137,059
Commercial real estate	1,217,249	1,267,432
Loans to individuals	586,278	565,849
Total loans and leases net of unearned income	4,214,299	$ 4,043,643

During the nine-months ended September 30, 2012, all loan categories, except commercial real estate, increased with total loans increasing $170.7 million or 4% compared to balances outstanding at December 31, 2011. A majority of the loan growth was recognized in the residential real estate portfolio as a result of seasonal demand and an ongoing loan promotion. Increases in commercial, financial, agricultural and other portfolio can be attributed to growth in direct middle market lending and syndications in Pennsylvania and contiguous states, while loans to individuals increased due to growth in home equity installment loans and indirect auto lending.

Credit Quality Information

As part of the on-going monitoring of credit quality within the loan portfolio, the following credit worthiness categories are used in grading our loans:

Pass — Acceptable levels of risk exist in the relationship. Includes all loans not adversely classified as OAEM, substandard or doubtful.

Other Assets Especially Mentioned (OAEM) — Potential weaknesses that deserve management s close attention. The potential weaknesses may result in deterioration of the repayment prospects or weaken the Bank s credit position at some future date. The credit risk may be relatively minor, yet constitute an undesirable risk in light of the circumstances surrounding the specific credit. No loss of principal or interest is expected.

Substandard — Well-defined weakness or a weakness that jeopardizes the repayment of the debt. A loan may be classified as substandard as a result of deterioration of the borrower s financial condition and repayment capacity. Loans for which repayment plans have not been met or collateral equity margins do not protect the Company may also be classified as substandard.

Doubtful — Loans with the characteristics of substandard loans with the added characteristic that collection or liquidation in full, on the basis of presently existing facts and conditions, is highly improbable.

The use of creditworthiness categories to grade loans permits management s use of migration analysis to estimate a portion of credit risk. The Company s internal creditworthiness grading system provides a measurement of credit risk based primarily on an evaluation of the borrower s cash flow and collateral. Movements between these rating categories provides a predictive measure of credit losses and therefore assists in determining the appropriate level for the loan loss reserves. Category ratings are reviewed each quarter, at which time management analyzes the

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 10 Loans and Allowance for Credit Losses (Continued)

Credit Quality Information (Continued)

results, as well as other external statistics and factors related to loan performance. Loans that migrate towards higher risk rating levels generally have an increased risk of default, whereas, loans that migrate toward lower risk ratings generally will result in a lower risk factor being applied to those related loan balances.

The following tables represent our credit risk profile by creditworthiness:

	September 30, 2012					
	Commercial, financial, agricultural and other	**Real estate construction**	**Residential real estate**	**Commercial real estate**	**Loans to individuals**	**Total**
	(dollars in thousands)					
Pass	$ 987,376	$ 71,995	$ 1,212,272	$ 1,087,424	$ 586,191	$ 3,945,258
Non-Pass						
OAEM	27,334	939	5,568	63,563	3	97,407
Substandard	72,309	18,205	10,488	66,262	84	167,348
Doubtful	0	4,286	0	0	0	4,286
Total Non-Pass	99,643	23,430	16,056	129,825	87	269,041
Total	$ 1,087,019	$ 95,425	$ 1,228,328	$ 1,217,249	$ 586,278	$ 4,214,299

	December 31, 2011					
	Commercial, financial, agricultural and other	**Real estate construction**	**Residential real estate**	**Commercial real estate**	**Loans to individuals**	**Total**
	(dollars in thousands)					
Pass	$ 904,057	$ 44,914	$ 1,126,143	$ 1,110,664	$ 565,842	$ 3,751,620
Non-Pass						
OAEM	27,627	4,238	5,484	61,855	7	99,211
Substandard	60,114	21,701	5,432	94,913	0	182,160
Doubtful	4,941	5,711	0	0	0	10,652
Total Non-Pass	92,682	31,650	10,916	156,768	7	292,023

Total	$ 996,739	$ 76,564	$ 1,137,059	$ 1,267,432	$ 565,849	$ 4,043,643

Portfolio Risks

Credit quality measures at September 30, 2012 compared to December 31, 2011 indicate a decrease in criticized loans, or loans designated OAEM, substandard or doubtful, of $23.0 million, or 8%, a decrease in delinquency 30 days and over on accruing loans of $10.2 million, or 29%, and an $8.3 million increase in nonaccrual loans, excluding loans held-for-sale.

Charge-offs for the nine-months ended September 30, 2012 totaled $13.4 million compared to $30.1 million for the nine-months ended September 30, 2011. The most significant charge-offs during the nine-months ended September 30, 2012 were a $1.4 million charge taken on a Florida real estate construction loan with a remaining balance of $4.3 million and a $1.2 million charge taken on a $2.0 million commercial loan relationship. During the nine-months ended September 30, 2011, the most significant charge-off totaled $5.2 million and related to a central Pennsylvania development loan relationship. Other significant charge-offs during the nine-month period

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 10 Loans and Allowance for Credit Losses (Continued)

Portfolio Risks (Continued)

in 2011 totaled $10.8 million and related to six construction loan projects located in Florida, Nevada, Ohio and western and central Pennsylvania.

Criticized loans totaled $269.0 million at September 30, 2012 and represented 6% of the loan portfolio. This represents a $23.0 million decrease compared with the portfolio as of December 31, 2011. These loans have been evaluated when determining the appropriateness of the allowance for credit losses, which we believe is adequate at this time. However, changes in economic conditions, interest rates, borrower financial condition, delinquency trends or previously established fair values of collateral factors could significantly change those judgmental estimates.

The credit quality of our loan portfolio represents significant risk to our earnings, capital, regulatory agency relationships and shareholder returns. First Commonwealth devotes a substantial amount of resources to managing this risk primarily through our credit administration department that develops and administers policies and procedures for underwriting, maintaining, monitoring and collecting activities. Credit administration is independent of lending departments and oversight is provided by the Credit Committee of the First Commonwealth Board of Directors.

Risk factors associated with commercial real estate and construction related loans are monitored closely since this is an area that represents a significant portion of the loan portfolio and has experienced the most stress during the economic downturn.

In addition, during the first nine months of 2012, nine relationships consisting of fifteen loans, were classified as troubled debt restructuring. These loans increased the nonperforming loan balance by $10.3 million with a $3.2 million increase in specific reserves.

Age Analysis of Past Due Loans by Segment

The following tables delineate the aging analysis of the recorded investments in past due loans as of September 30, 2012 and December 31, 2011. Also included in these tables are loans that are 90 days or more past due and still accruing because they are well-secured and in the process of collection.

	September 30, 2012						
	30 - 59 days past due	**60 - 89 days past due**	**90 days and greater and still accruing**	**Nonaccrual**	**Total past due and nonaccrual**	**Current**	**Total**
				(dollars in thousands)			
Commercial, financial, agricultural and other	$ 1,440	$ 679	$ 221	$ 28,827	$ 31,167	$ 1,055,852	$ 1,087,019
Real estate construction	235	0	152	11,569	11,956	83,469	95,425
Residential real estate	7,642	1,986	1,277	8,910	19,815	1,208,513	1,228,328
Commercial real estate	6,651	169	162	37,340	44,322	1,172,927	1,217,249
Loans to individuals	2,684	820	1,186	84	4,774	581,504	586,278

Total	$ 18,652	$ 3,654	$ 2,998	$ 86,730	$ 112,034	$ 4,102,265	$ 4,214,299

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ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 10 Loans and Allowance for Credit Losses (Continued)

Age Analysis of Past Due Loans by Segment (Continued)

	December 31, 2011						
	30 - 59 days past due	60 - 89 days past due	90 days and greater and still accruing	Nonaccrual	Total past due and nonaccrual	Current	Total
	(dollars in thousands)						
Commercial, financial, agricultural and other	$ 5,433	$ 824	$ 287	$ 33,459	$ 40,003	$ 956,736	$ 996,739
Real estate construction	0	180	0	14,911	15,091	61,473	76,564
Residential real estate	7,144	2,100	8,767	3,153	21,164	1,115,895	1,137,059
Commercial real estate	3,671	1,241	157	26,953	32,022	1,235,410	1,267,432
Loans to individuals	2,952	962	1,804	0	5,718	560,131	565,849
Total	$ 19,200	$ 5,307	$ 11,015	$ 78,476	$ 113,998	$ 3,929,645	$ 4,043,643

The previous tables summarize nonaccrual loans by loan segment. The Company generally places loans on nonaccrual status when the full and timely collection of interest or principal becomes uncertain, when part of the principal balance has been charged off and no restructuring has occurred, or the loans reach a certain number of days past due. Generally, loans 90 days or more past due are placed on nonaccrual status, except for consumer loans which are placed in nonaccrual status at 150 days past due. In periods prior to the third quarter of 2012, if a consumer loan was well secured and in the process of collection, it remained on accrual status, as delinquency was not a factor in moving it to nonaccrual status.

Nonaccrual Loans

When a loan is placed on nonaccrual, the accrued unpaid interest receivable is reversed against interest income and all future payments received are applied as a reduction to the loan principal. Generally, the loan is returned to accrual status when (a) all delinquent interest and principal become current under the terms of the loan agreement or (b) the loan is both well-secured and in the process of collection and collectability is no longer doubtful.

Impaired Loans

Management considers loans to be impaired when, based on current information and events, it is determined that the Company will not be able to collect all amounts due according to the loan contract, including scheduled interest payments. Determination of impairment is treated the same across all loan categories. When management identifies a loan as impaired, the impairment is measured based on the present value of expected future cash flows, discounted at the loan s effective interest rate, except when the sole source for repayment of the loan is the operation or liquidation of collateral. When the loan is collateral dependent, the appraised value less estimated cost to sell is utilized. If management determines the value of the impaired loan is less than the recorded investment in the loan, impairment is recognized through an allowance estimate or a charge-off to the allowance. Troubled debt restructured loans on accrual status are considered to be impaired loans.

When the ultimate collectability of the total principal of an impaired loan is in doubt and the loan is on nonaccrual status, all payments are applied to principal, under the cost recovery method. When the ultimate collectability of the total principal of an impaired loan is not in doubt and the loan is on nonaccrual status, contractual interest is credited to interest income when received, under the cash basis method.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 10 Loans and Allowance for Credit Losses (Continued)

Impaired Loans (Continued)

Nonperforming loans, excluding loans held for sale, decreased $4.9 million to $93.9 million at September 30, 2012 compared to $98.8 million at December 31, 2011. Contributing to this decrease was an $11.3 million loan to a waste management company which was paid off in the first quarter and a $10.3 million loan to an information technology firm which was returned to accrual status in the second quarter. The most significant loans placed into nonperforming status during the first nine months of 2012 included $6.7 million to a western Pennsylvania in-patient facility, $4.9 million for a commercial real estate loan to a nonprofit institution, $2.5 million to a manufacturer of medical equipment and $2.8 million to a western Pennsylvania construction firm. During the third quarter of 2012, a $0.9 million payment was received on the aforementioned $4.9 million loan to a nonprofit, providing for a current balance on this loan of $3.9 million. Also impacting the balance of nonperforming loans for the period was the movement to nonaccrual status of $4.8 million in consumer loans which were 150 days or more past due. Beginning in the third quarter of 2012, consumer loans are moved to nonaccrual status once they reach 150 days past due, however, in prior periods, these loans were not placed in nonaccrual status if they were well secured and in the process of collection. The majority of the consumer loans moved to nonaccrual status in the third quarter, or $4.7 million of the $4.8 million, were residential real estate loans.

The specific allowance for nonperforming loans decreased by $0.3 million at September 30, 2012 compared to December 31, 2011, primarily due to the decrease in balances. Unfunded commitments related to nonperforming loans were $5.1 million at September 30, 2012 and after consideration of available collateral related to these commitments, an off balance sheet reserve of $44 thousand was established.

Loans held for sale totaled $13.4 million at December 31, 2011 and the entire balance represented nonperforming loans. As of September 30, 2012, the sale of all of these loans had been completed and provided for a $2.9 million gain. While these loans were considered to be nonperforming, they were not taken into consideration when determining the allowance for credit losses as they were carried at the lower of cost or fair value.

Significant nonaccrual loans as of September 30, 2012, include the following;

$19.3 million, the remaining portion of a $44.1 million unsecured loan to a western Pennsylvania real estate developer. This loan was originated in the second quarter of 2004 and was placed in nonaccrual status in the fourth quarter of 2009. A settlement plan with the borrower and three other lenders was reached in the fourth quarter of 2010 and resulted in an $8.0 million principal payment and a $15.4 million partial charge-off.

$16.0 million commercial real estate loan for a real estate developer in eastern Pennsylvania. This loan was originated in the third quarter of 2007 and restructured in the fourth quarter of 2011which resulted in a charge-off of $4.2 million. The most recent appraisal for the real estate collateral was completed in the third quarter of 2011.

$6.7 million commercial real estate loan to an in-patient facility in western Pennsylvania. This loan was originated in the fourth quarter of 2008 and placed in nonaccrual status in September 2012. Because this loan was not previously classified, the most recent appraisal for the real estate collateral was at loan origination. Therefore, the collateral valuation and resulting shortfall on this loan were determined using a real estate common level ratio.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 10 Loans and Allowance for Credit Losses (Continued)

Impaired Loans (Continued)

$4.3 million, the remaining portion of a $20.8 million construction loan for a Florida condominium project. This loan was originated in the second quarter of 2007. Charge-offs of $16.5 million have been recorded on this loan. The most recent appraisal for the real estate collateral was completed in the second quarter of 2012.

$3.9 million real estate secured loan to a western Pennsylvania nonprofit corporation. This loan was originated in the fourth quarter of 2008 and placed in nonaccrual status in the second quarter of 2012. The most recent appraisals for the various real estate collateral were completed in the fourth quarter of 2011 and the first quarter of 2012.

The following tables include the recorded investment and unpaid principal balance for impaired loans with the associated allowance amount, if applicable, as of September 30, 2012 and December 31, 2011. Also presented are the average recorded investment in impaired loans and the related amount of interest recognized while the loan was considered impaired. Average balances are calculated based on month-end balances of the loans of the period reported.

	September 30, 2012			December 31, 2011		
	Recorded investment	Unpaid principal balance	Related allowance	Recorded investment	Unpaid principal balance	Related allowance
	(dollars in thousands)					
With no related .allowance recorded:						
Commercial, financial, agricultural and other	$ 6,762	$ 7,716	$ 0	$ 2,010	$ 3,418	$ 0
Real estate construction	4,087	7,424	0	10,814	20,161	0
Residential real estate	7,087	7,556	0	3,125	3,513	0
Commercial real estate	29,394	31,055	0	36,777	41,974	0
Loans to individuals	84	84	0	0	0	0
Subtotal	47,414	53,835	0	52,726	69,066	0
With an allowance recorded:						
Commercial, financial, agricultural and other	26,719	27,558	7,306	34,056	34,341	9,069
Real estate construction	7,482	30,312	973	6,298	21,402	2,960
Residential real estate	2,752	2,752	719	955	955	93
Commercial real estate	9,539	9,752	3,916	4,717	4,863	1,114
Loans to individuals	0	0	0	0	0	0
Subtotal	46,492	70,374	12,914	46,026	61,561	13,236
Total	$ 93,906	$ 124,209	$ 12,914	$ 98,752	$ 130,627	$ 13,236

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 10 Loans and Allowance for Credit Losses (Continued)

Impaired Loans (Continued)

	For the Nine-Months Ended September 30,			
	2012		2011	
	Average recorded investment	Interest Income Recognized	Average recorded investment	Interest Income Recognized
	(dollars in thousands)			
With no related allowance recorded:				
Commercial, financial, agricultural and other	$ 9,281	$ 116	$ 3,695	$ 11
Real estate construction	6,641	0	21,611	1
Residential real estate	7,604	17	2,519	4
Commercial real estate	27,869	50	27,322	246
Loans to individuals	9	0	13	0
Subtotal	51,404	183	55,160	262
With an allowance recorded:				
Commercial, financial, agricultural and other	21,025	5	29,614	126
Real estate construction	7,381	0	19,858	0
Residential real estate	1,532	20	422	1
Commercial real estate	2,713	11	35,595	301
Loans to individuals	0	0	0	0
Subtotal	32,651	36	85,489	428
Total	$ 84,055	$ 219	$ 140,649	$ 690

	For the Three-Months Ended September 30,			
	2012		2011	
	Average recorded investment	Interest Income Recognized	Average recorded investment	Interest Income Recognized
	(dollars in thousands)			
With no related allowance recorded:				
Commercial, financial, agricultural and other	$ 6,664	$ 94	$ 1,989	$ 6
Real estate construction	4,954	0	16,465	(1)
Residential real estate	4,374	6	3,131	3
Commercial real estate	29,878	14	19,676	228
Loans to individuals	28	0	7	0
Subtotal	45,898	114	41,268	236
With an allowance recorded:				
Commercial, financial, agricultural and other	25,469	2	37,552	50

Real estate construction	8,848	0	20,237	(2)
Residential real estate	2,130	6	669	1
Commercial real estate	4,754	11	51,677	124
Loans to individuals	0	0	0	0
Subtotal	41,201	19	110,135	173
Total	$ 87,099	$ 133	$ 151,403	$ 409

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ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 10 Loans and Allowance for Credit Losses (Continued)

Impaired Loans (Continued)

Troubled debt restructured loans are those loans whose terms have been renegotiated to provide a reduction or deferral of principal or interest as a result of the financial difficulties experienced by the borrower, who could not obtain comparable terms from alternate financing sources.

The following table provides detail as to the total troubled debt restructured loans and total commitments outstanding on troubled debt restructured loans:

	September 30, 2012	December 31, 2011
	(dollars in thousands)	
Troubled debt restructured loans		
Accrual status	$ 7,176	$ 20,276
Nonaccrual status	46,026	44,841
Total	$ 53,202	$ 65,117
Commitments		
Letters of credit	$ 0	$ 12,580
Unused lines of credit	1,342	42
Total	$ 1,342	$ 12,622

At September 30, 2012, troubled debt restructured loans on accruing status decreased $13.1 million compared to December 31, 2011 and commitments related to troubled debt restructured loans decreased $11.3 million for the same period. These decreases are primarily a result of the payoff of an $11.3 million loan to a waste management company in Pennsylvania as a result of the sale of the business. In addition, a $2.2 million loan to a retail development company in western Pennsylvania paid off during the first quarter. During 2012 and 2011 the changes in loan balances between the pre-modification balance and the post-modification balance are due to customer payments.

The following tables provide detail, including specific reserve and reasons for modification, related to loans identified as troubled debt restructurings:

	For the Nine-Months Ended September 30, 2012						
		Type of Modification					
	Number of Contracts	Extend Maturity	Modify Rate	Modify Payments	Total Pre-Modification Outstanding	Post-Modification Outstanding	Specific Reserve

					Recorded Investment	Recorded Investment	
				(dollars in thousands)			
Commercial, financial, agricultural and other	10	$ 1,599	$ 187	$ 7,538	$ 9,324	$ 8,885	$ 3,140
Real estate construction	1	823	0	0	823	791	0
Residential real estate	3	0	97	83	180	131	0
Commercial real estate	1	0	516	0	516	529	98
Total	15	$ 2,422	$ 800	$ 7,621	$ 10,843	$ 10,336	$ 3,238

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ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 10 Loans and Allowance for Credit Losses (Continued)

Impaired Loans (Continued)

	For the Nine-Months Ended September 30, 2011						
	Type of Modification						
	Number of Contracts	Extend Maturity	Modify Rate	Modify Payments	Total Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Specific Reserve
	(dollars in thousands)						
Commercial, financial, agricultural and other	10	$ 100	$ 105	$ 2,218	$ 2,423	$ 2,402	$ 606
Real estate construction	4	354	0	0	354	506	0
Residential real estate	5	0	100	179	279	274	7
Commercial real estate	18	17,202	199	1,978	19,379	19,237	1,551
Total	37	$ 17,656	$ 404	$ 4,375	$ 22,435	$ 22,419	$ 2,164

The troubled debt restructurings included in the above tables are also included in the impaired loan tables provided earlier in this note. Loans defined as modified due to a change in rate include loans that were modified for a change in rate as well as a reamortization of the principal and an extension of the maturity. For the nine-months ended September 30, 2012 and 2011, $0.8 million and $0.3 million, respectively, of total rate modifications represent loans with modifications to the rate as well as payment due to reamortization.

The following tables provide detail, including specific reserve and reasons for modification, related to loans identified as troubled debt restructurings:

	For the Three-Months Ended September 30, 2012						
	Type of Modification						
	Number of Contracts	Extend Maturity	Modify Rate	Modify Payments	Total Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Specific Reserve
	(dollars in thousands)						
Commercial, financial, agricultural and other	6	$ 1,153	$ 169	$ 1,509	$ 2,831	$ 3,004	$ 746
Real estate construction	0	0	0	0	0	0	0
Residential real estate	0	0	0	0	0	0	0
Commercial real estate	1	0	516	0	516	529	98

Total	7	$ 1,153	$ 685	$ 1,509	$ 3,347	$ 3,533	$ 844

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 10 Loans and Allowance for Credit Losses (Continued)

Impaired Loans (Continued)

	For the Three-Months Ended September 30, 2011						
		Type of Modification					
	Number of Contracts	Extend Maturity	Modify Rate	Modify Payments	Total Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Specific Reserve
	(dollars in thousands)						
Commercial, financial, agricultural and other	1	$ 0	$ 0	$ 50	$ 50	$ 46	$ 0
Real estate construction	0	0	0	0	0	0	0
Residential real estate	2	0	73	104	177	175	7
Commercial real estate	3	39	0	481	520	517	0
Total	6	$ 39	$ 73	$ 635	$ 747	$ 738	$ 7

The troubled debt restructurings included in the above tables are also included in the impaired loan tables provided earlier in this note. Loans defined as modified due to a change in rate include loans that were modified for a change in rate as well as a reamortization of the principal and an extension of the maturity. For the three-months ended September 30, 2012, $0.7 million of total rate modifications represent loans with modifications to the rate as well as payment due to reamortization. There were no loans for the three-months ended September 30, 2011 with modifications to rate as well as payment.

A troubled debt restructuring is considered to be in default when a restructured loan is 90 days or more past due. There were no loans restructured over the previous twelve months considered to default during the three-months ended September 30, 2012 and 2011. The following provides information related to restructured loans that were considered to default during the nine-months ended September 30:

	2012		2011	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
	(dollars in thousands)			
Real estate construction	0	$ 0	1	$ 88
Total	0	$ 0	1	$ 88

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 10 Loans and Allowance for Credit Losses (Continued)

Impaired Loans (Continued)

The following tables provide detail related to the allowance for credit losses:

	For the Nine-Months Ended September 30, 2012						
	Commercial, financial, agricultural and other	Real estate construction	Residential real estate	Commercial real estate (dollars in thousands)	Loans to individuals	Unallocated	Total
Allowance for credit losses:							
Beginning Balance	$ 18,200	$ 6,756	$ 8,237	$ 18,961	$ 4,244	$ 4,836	$ 61,234
Charge-offs	(4,939)	(2,356)	(2,984)	(638)	(2,494)	0	(13,411)
Recoveries	349	121	331	256	396	0	1,453
Provision	4,470	4,341	1,120	1,855	2,074	978	14,838
Ending Balance	$ 18,080	$ 8,862	$ 6,704	$ 20,434	$ 4,220	$ 5,814	$ 64,114
Ending balance: individually evaluated for impaired	$ 7,306	$ 973	$ 719	$ 3,916	$ 0	$ 0	$ 12,914
Ending balance: collectively evaluated for impaired	10,774	7,889	5,985	16,518	4,220	5,814	51,200
Loans:							
Ending balance	1,087,019	95,425	1,228,328	1,217,249	586,278		4,214,299
Ending balance: individually evaluated for impaired	32,833	11,427	7,224	37,369	0		88,853
Ending balance: collectively evaluated for impaired	1,054,186	83,998	1,221,104	1,179,880	586,278		4,125,446

	For the Nine-Months Ended September 30, 2011						
	Commercial, financial, agricultural and other	Real estate construction	Residential real estate	Commercial real estate (dollars in thousands)	Loans to individuals	Unallocated	Total
Allowance for credit losses:							
Beginning Balance	$ 21,700	$ 18,002	$ 5,454	$ 16,913	$ 4,215	$ 4,945	$ 71,229
Charge-offs	(3,642)	(14,570)	(2,686)	(6,918)	(2,332)	0	(30,148)
Recoveries	335	0	118	239	440	0	1,132
Provision	196	11,984	3,770	12,443	1,708	(197)	29,904

Ending Balance	$ 18,589	$ 15,416	$ 6,656	$ 22,677	$ 4,031	$ 4,748	$ 72,117
Ending balance: individually evaluated for impaired	$ 10,503	$ 12,551	$ 171	$ 11,674	$ 0	$ 0	$ 34,899
Ending balance: collectively evaluated for impaired	8,086	2,865	6,485	11,003	4,031	4,748	37,218
Loans:							
Ending balance	950,547	97,354	1,096,339	1,284,720	544,763		3,973,723
Ending balance: individually evaluated for impaired	37,738	35,957	2,290	81,375	0		157,360
Ending balance: collectively evaluated for impaired	912,809	61,397	1,094,049	1,203,345	544,763		3,816,363

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 10 Loans and Allowance for Credit Losses (Continued)

Impaired Loans (Continued)

	For the Three-Months Ended September 30, 2012						
	Commercial, financial, agricultural and other	Real estate construction	Residential real estate	Commercial real estate (dollars in thousands)	Loans to individuals	Unallocated	Total
Allowance for credit losses:							
Beginning Balance	$ 19,302	$ 8,001	$ 6,619	$ 17,638	$ 4,209	$ 5,907	$ 61,676
Charge-offs	(1,271)	(2,016)	(530)	(97)	(756)	0	(4,670)
Recoveries	74	29	49	70	132	0	354
Provision	(25)	2,848	566	2,823	635	(93)	6,754
Ending Balance	$ 18,080	$ 8,862	$ 6,704	$ 20,434	$ 4,220	$ 5,814	$ 64,114

	For the Three-Months Ended September 30, 2011						
	Commercial, financial, agricultural and other	Real estate construction	Residential real estate	Commercial real estate (dollars in thousands)	Loans to individuals	Unallocated	Total
Allowance for credit losses:							
Beginning Balance	$ 23,175	$ 17,701	$ 6,870	$ 18,780	$ 3,870	$ 4,770	$ 75,166
Charge-offs	(685)	(6,522)	(986)	(1,343)	(810)	0	(10,346)
Recoveries	74	0	22	75	151	0	322
Provision	(3,975)	4,237	750	5,165	820	(22)	6,975
Ending Balance	$ 18,589	$ 15,416	$ 6,656	$ 22,677	$ 4,031	$ 4,748	$ 72,117

Note 11 Income Taxes

At September 30, 2012 and December 31, 2011, First Commonwealth had no material unrecognized tax benefits or accrued interest and penalties. If applicable, First Commonwealth will record interest and penalties as a component of noninterest expense. Federal and state tax years 2009 through 2011 were open for examination as of September 30, 2012.

Note 12 Fair Values of Assets and Liabilities

FASB ASC Topic 820, Fair Value Measurements and Disclosures requires disclosures for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). All non-financial assets are included either as a separate line item on the Condensed Consolidated Statements of Financial Condition or in the Other assets category of the Condensed Consolidated Statements of Financial Condition. Currently, First Commonwealth does not have any non-financial liabilities to disclose.

FASB ASC Topic 825, Financial Instruments permits entities to irrevocably elect to measure select financial instruments and certain other items at fair value. The unrealized gains and losses are required to be included in earnings each reporting period for the items that fair value measurement is elected. First Commonwealth has elected not to measure any existing financial instruments at fair value under FASB ASC Topic 825; however, in the future we may elect to adopt this guidance for select financial instruments.

FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 12 Fair Values of Assets and Liabilities (Continued)

In accordance with FASB ASC Topic 820, First Commonwealth groups financial assets and financial liabilities measured at fair value in three levels based on the principal markets in which the assets and liabilities are transacted and the observability of the data points used to determine fair value. These levels are:

Level 1 Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange (NYSE). Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities. Level 1 securities include equity holdings comprised of publicly traded bank stocks which were priced using quoted market prices.

Level 2 Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained for identical or comparable assets or liabilities from alternative pricing sources with reasonable levels of price transparency. Level 2 includes Obligations of U.S. Government securities issued by Agencies and Sponsored Enterprises, Obligations of States and Political Subdivisions, certain corporate securities, FHLB stock, interest rate derivatives that include interest rate swaps and risk participation agreements, certain other real estate owned and certain impaired loans.

Level 2 investment securities are valued by a recognized third party pricing service using observable inputs. The model used by the pricing service varies by asset class and incorporates available market, trade and bid information as well as cash flow information when applicable. Because many fixed-income investment securities do not trade on a daily basis, the model uses available information such as benchmark yield curves, benchmarking of like investment securities, sector groupings and matrix pricing. The model will also use processes such as an option adjusted spread to assess the impact of interest rates and to develop prepayment estimates. Market inputs normally used in the pricing model include benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data including market research publications.

Management validates the market values provided by the third party service by having another recognized pricing service price a random sample of securities each quarter, monthly monitoring of variances from prior period pricing and, on a monthly basis, evaluating pricing changes compared to expectations based on changes in the financial markets.

Other investments are comprised of FHLB stock whose fair value is based on its par value. Additional information on FHLB stock is provided in Note 8, Other Investments.

Interest rate derivatives are reported at an estimated fair value utilizing Level 2 inputs and are included in other assets and other liabilities and consist of interest rate swaps where there is no significant deterioration in the counterparties (loan customers) credit risk since origination of the interest rate swap. First Commonwealth values its interest rate swap positions using a yield curve by taking market prices/rates for an appropriate set of instruments. The set of instruments currently used to determine the U.S. Dollar yield curve includes cash LIBOR rates from overnight to three months, Eurodollar futures contracts and swap rates from three years to thirty years. These yield curves determine the valuations of interest rate swaps. Interest rate derivatives are further described in Note 13, Derivatives.

For purposes of potential valuation adjustments to our derivative positions, First Commonwealth evaluates the credit risk of its counterparties as well as our own credit risk. Accordingly, we have considered factors such as the likelihood of default, expected loss given default, net exposures and remaining contractual life, among other

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 12 Fair Values of Assets and Liabilities (Continued)

things, in determining if any fair value adjustments related to credit risk are required. We review our counterparty exposure quarterly, and when necessary, appropriate adjustments are made to reflect the exposure.

We also utilize this approach to estimate our own credit risk on derivative liability positions. In 2012, we have not realized any losses due to a counterparty s inability to pay any net uncollateralized position.

The fair value for other real estate owned included in Level 2 is determined by either an independent market based appraisal less estimated costs to sell or an executed sales agreement.

Level 3 Valuations for assets and liabilities that are derived from other valuation methodologies, including option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer or broker traded transactions. If the inputs used to provide the valuation are unobservable and/or there is very little, if any, market activity for the security or similar securities, the securities would be considered Level 3 securities. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities. The assets included in Level 3 are pooled trust preferred collateralized debt obligations, non-marketable equity investments, loans held for sale and certain interest rate derivatives, certain other real estate owned and certain impaired loans.

Our pooled trust preferred collateralized debt obligations are collateralized by the trust preferred securities of individual banks, thrifts and bank holding companies in the U.S. There has been little or no active trading in these securities since 2009; therefore it was more appropriate to determine fair value using a discounted cash flow analysis. Detail on our process for determining the appropriate cash flows for this analysis is provided in Note 9, Impairment of Investment Securities. The discount rate applied to the cash flows is determined by evaluating the current market yields for comparable corporate and structured credit products along with an evaluation of the risks associated with the cash flows of the comparable security. Due to the fact that there is no active market for the pooled trust preferred collateralized debt obligations, one key reference point is the market yield for the single issue trust preferred securities issued by banks and thrifts for which there is more activity than for the pooled securities. Adjustments are then made to reflect the credit and structural differences between these two security types.

Management validates the fair value of the pooled trust preferred collateralized debt obligations by monitoring the performance of the underlying collateral, discussing the discount rate, cash flow assumptions and general market trends with the specialized third party and confirming changes in the underlying collateral to the trustee reports. Management s monitoring of the underlying collateral includes deferrals of interest payments, payment defaults, cures of previously deferred interest payments, any regulatory filings or actions and general news related to the underlying collateral. Management also evaluates fair value changes compared to expectations based on changes in the interest rates used in determining the discount rate and general financial markets.

The estimated fair value of the non-marketable equity investments included in Level 3 is based on par value.

Loans held for sale are carried at the lower of cost or fair value with the fair value being the expected sales price of the loan. The estimated fair value of the loans held for sale was determined by calculating the discounted expected future cash flows of the loan. The discount rate applied to the future cash flows was determined based on a risk based expected return and capital structure of potential buyers. If a sales agreement has been executed, the fair value is equal to the sales price.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 12 Fair Values of Assets and Liabilities (Continued)

For interest rate derivatives included in Level 3, the fair value incorporates credit risk by considering such factors as likelihood of default and expected loss given default based on the credit quality of the underlying counterparties (loan customers).

In 2012, we have not realized any losses due to a counterparty s inability to pay any net uncollateralized position. However, as the result of deterioration in the counterparties (loan customers) credit quality for certain interest rate derivatives, future amounts previously believed to be collectible under the terms of the interest rate derivative have now been deemed to be uncollectible.

In accordance with ASU 2011-04, the following table provides information related to quantitative inputs and assumptions used in Level 3 fair value measurements.

	Fair Value (dollars in thousands)	**Valuation Technique**	**Unobservable Inputs**	**Range / (weighted average)**
Pooled Trust Preferred Securities	$23,051	Discounted Cash Flow	Probability of default	0% -100% (21.73%)
			Prepayment rates	0% -100% (13.44%)
			Discount rates	6.75% - 20%(a)
Other Investments	1,420	Par Value	N/A	N/A
Interest Rate Swap	0	Option model	Counterparty credit risk	15.08% - 17.63%(b)
Impaired Loans	15,755(c)	Discounted Cash Flow	Discount rate	8.42% - 8.83%
Other Real Estate Owned	338	Internal Valuation	N/A	N/A

(a) incorporates premium related to credit quality and illiquidity of securities.
(b) represents the range of the credit spread curve used in valuation.
(c) the remainder of impaired loans valued using Level 3 inputs are not included in this disclosure as the values of those loans are based on bankruptcy agreement documentation.

The significant unobservable inputs used in the fair value measurement of pooled trust preferred securities are the probability of default, discount rates and prepayment rates. Significant increases in the probability of default or discount rate used would result in a decrease in the estimated fair value of these securities while decreases in these variables would result in higher fair value measurements. In general, a change in the assumption of probability of default is accompanied by a directionally similar change in the discount rate. In most cases, increases in the prepayment rate assumptions would result in a higher estimated fair value for these securities while decreases would provide for a lower value. The direction of this change is somewhat dependent on the structure of the investment and the amount of the investment tranches senior to our position.

The discount rate is the significant unobservable input used in the fair value measurement of impaired loans. Significant increases in this rate would result in a decrease in the estimated fair value of the loans, while a decrease in this rate would result in higher fair value measurement.

The significant unobservable input used in the fair value measurement of interest rate swaps classified as Level 3 is counterparty credit risk and the resulting range of the credit spread curve used in the valuation. Higher credit risk would result in an increased credit spread, which would

reduce the fair value of the interest rate swap.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 12 Fair Values of Assets and Liabilities (Continued)

The tables below present the balances of assets and liabilities measured at fair value on a recurring basis:

	September 30, 2012			
	Level 1	Level 2	Level 3	Total
	(dollars in thousands)			
Obligations of U.S. Government Agencies:				
Mortgage-Backed Securities Residential	$ 0	$ 33,355	$ 0	$ 33,355
Obligations of U.S. Government-Sponsored Enterprises:				
Mortgage-Backed Securities Residential	0	818,278	0	818,278
Mortgage-Backed Securities Commercial	0	166	0	166
Other Government-Sponsored Enterprises	0	242,881	0	242,881
Obligations of States and Political Subdivisions	0	87	0	87
Corporate Securities	0	11,144	0	11,144
Pooled Trust Preferred Collateralized Debt Obligations	0	0	23,051	23,051
Total Debt Securities	0	1,105,911	23,051	1,128,962
Equities	440	0	1,420	1,860
Total Securities Available for Sale	440	1,105,911	24,471	1,130,822
Other Investments	0	32,479	0	32,479
Other Assets[a]	0	18,122	0	18,122
Total Assets	$ 440	$ 1,156,512	$ 24,471	$ 1,181,423
Other Liabilities[a]	$ 0	$ 20,004	$ 0	$ 20,004
Total Liabilities	$ 0	$ 20,004	$ 0	$ 20,004

(a) Non-hedging interest rate derivatives

	December 31, 2011			
	Level 1	Level 2	Level 3	Total
	(dollars in thousands)			
Obligations of U.S. Government Agencies:				
Mortgage-Backed Securities Residential	$ 0	$ 36,194	$ 0	$ 36,194
Obligations of U.S. Government-Sponsored Enterprises:				
Mortgage-Backed Securities Residential	0	801,031	0	801,031
Mortgage-Backed Securities Commercial	0	193	0	193

Other Government-Sponsored Enterprises	0	268,648	0	268,648
Obligations of States and Political Subdivisions	0	459	0	459
Corporate Securities	0	11,411	0	11,411
Pooled Trust Preferred Collateralized Debt Obligations	0	0	22,980	22,980
Total Debt Securities	0	1,117,936	22,980	1,140,916
Equities	440	0	1,420	1,860
Total Securities Available for Sale	440	1,117,936	24,400	1,142,776
Other Investments	0	39,796	0	39,796
Loans Held for Sale	0	0	13,412	13,412
Other Assets[a]	0	16,064	0	16,064
Total Assets	$ 440	$ 1,173,796	$ 37,812	$ 1,212,048
Other Liabilities[a]	$ 0	$ 18,986	$ 0	$ 18,986
Total Liabilities	$ 0	$ 18,986	$ 0	$ 18,986

(a) Non-hedging interest rate derivatives

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 12 Fair Values of Assets and Liabilities (Continued)

For the nine-month periods ended September 30, changes in Level 3 assets and liabilities measured at fair value on a recurring basis are summarized as follows:

	2012				
	Pooled Trust Preferred Collateralized Debt Obligations	Equities	Loans Held for Sale	Other Assets	Total
	(dollars in thousands)				
Balance, beginning of period	$ 22,980	$ 1,420	$ 13,412	$ 0	$ 37,812
Total gains or losses					
Included in earnings	0	0	2,870	(461)	2,409
Included in other comprehensive income	3,610	0	0	0	3,610
Purchases, issuances, sales, and settlements					
Purchases	0	0	0	0	0
Issuances	0	0	0	0	0
Sales	0	0	(15,981)	0	(15,981)
Settlements	(3,539)	0	(301)	0	(3,840)
Transfers into Level 3	0	0	0	461	461
Balance, end of period	$ 23,051	$ 1,420	$ 0	$ 0	$ 24,471

	2011					
	Obligations of States and Political Subdivisions	Corporate Securities	Pooled Trust Preferred Collateralized Debt Obligations	Equities	Other Assets	Total
	(dollars in thousands)					
Balance, beginning of period	$ 343	$ 21,376	$ 26,352	$ 1,570	$ 0	49,641
Total gains or losses						
Included in earnings	4	387	0	0	(4,520)	(4,129)
Included in other comprehensive income	(20)	(98)	809	0	0	691
Purchases, issuances, sales, and settlements						
Purchases	0	0	0	0	0	0
Issuances	0	0	0	0	0	0
Sales	(327)	(6,700)	0	0	0	(7,027)
Settlements	0	(3,000)	(2,463)	0	0	(5,463)

Transfers from Level 3		0		(11,965)		0		0		0	(11,965)
Transfers into Level 3		0		0		0		0		4,520	4,520
Balance, end of period	$	0	$	0	$	24,698	$	1,570	$	0	$ 26,268

For the nine-months ended September 30, 2012, there were no transfers between fair value Levels 1 and 2. However, $0.5 million of interest rate swaps were transferred into Level 3 from Level 2 due to deterioration of the counterparty s credit risk. Because the credit quality of the underlying counterparty declined below investment grade, the swaps were valued utilizing more than interest rate yield curves. During the second quarter of 2011, $12.0 million of corporate securities were transferred from Level 3 to Level 2. Corporate securities were transferred from Level 3 to Level 2 based on increased frequency in the volume of observable trades. Fair values

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 12 Fair Values of Assets and Liabilities (Continued)

on these securities at September 30, 2011 were determined based on market data, including trade and bid prices. During the third quarter of 2011, $4.5 million of interest rate swaps were transferred into Level 3 from Level 2 also due to deterioration of the counterparty s credit risk. There were no gains or losses included in earnings for the periods presented that are attributable to the change in realized gains (losses) relating to assets held at September 30, 2012 and 2011.

For the three-month periods ended September 30, changes in Level 3 assets and liabilities measured at fair value on a recurring basis are summarized as follows:

	2012				
	Pooled Trust Preferred Collateralized Debt Obligations	Equities	Loans Held for Sale	Other Assets	Total
	(dollars in thousands)				
Balance, beginning of period	$ 21,792	$ 1,420	$ 0	$ 0	$ 23,212
Total gains or losses					
Included in earnings	0	0	0	0	0
Included in other comprehensive income	2,030	0	0	0	2,030
Purchases, issuances, sales, and settlements					
Purchases	0	0	0	0	0
Issuances	0	0	0	0	0
Sales	0	0	0	0	0
Settlements	(771)	0	0	0	(771)
Transfers from Level 3	0	0	0	0	0
Transfers into Level 3	0	0	0	0	0
Balance, end of period	$ 23,051	$ 1,420	$ 0	$ 0	$ 24,471

	2011					
	Obligations of States and Political Subdivisions	Corporate Securities	Pooled Trust Preferred Collateralized Debt Obligations	Equities	Other Assets	Total
	(dollars in thousands)					
Balance, beginning of period	$ 0	$ 0	$ 26,984	$ 1,570	$ 0	28,554
Total gains or losses						
Included in earnings	0	0	0	0	(4,520)	(4,520)

Included in other comprehensive income	0	0	(2,211)	0	0	(2,211)
Purchases, issuances, sales, and settlements						
Purchases	0	0	0	0	0	0
Issuances	0	0	0	0	0	0
Sales	0	0	0	0	0	0
Settlements	0	0	(75)	0	0	(75)
Transfers from Level 3	0	0	0	0	4,520	4,520
Balance, end of period	$ 0	$ 0	$ 24,698	$ 1,570	$ 0	$ 26,268

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 12 Fair Values of Assets and Liabilities (Continued)

For the three-months ended September 30, 2012, there were no transfers of securities between Levels 1, 2 or 3. During the third quarter of 2011, $4.5 million of interest rate swaps were transferred into Level 3 from Level 2 due to deterioration of the counterparty s credit risk. There were no gains or losses included in earnings for the periods presented that are attributable to the change in realized gains (losses) relating to assets held at September 30, 2012 and 2011.

The tables below present the balances of assets measured at fair value on a non-recurring basis at:

	September 30, 2012			
	Level 1	**Level 2**	**Level 3**	**Total**
	(dollars in thousands)			
Impaired loans	$ 0	$ 59,241	$ 21,751	$ 80,992
Other real estate owned	0	16,002	338	16,340
Total Assets	$ 0	$ 75,243	$ 22,089	$ 97,332

	December 31, 2011			
	Level 1	**Level 2**	**Level 3**	**Total**
	(dollars in thousands)			
Impaired loans	$ 0	$ 73,783	$ 26,349	$ 100,132
Other real estate owned	0	31,232	438	31,670
Total Assets	$ 0	$ 105,015	$ 26,787	$ 131,802

The following losses were realized on the assets measured on a nonrecurring basis:

	For the Three-Months Ended September 30,		For the Nine-Months Ended September 30,	
	2012	**2011**	**2012**	**2011**
	(dollars in thousands)			
Impaired loans	$ (3,890)	$ (7,148)	$ (7,352)	$ (28,075)
Other real estate owned	(366)	(88)	(523)	(4,185)
Total losses	$ (4,256)	$ (7,236)	$ (7,875)	$ (32,260)

Impaired loans over $0.1 million are individually reviewed to determine the amount of each loan considered to be at risk of non-collection. The fair value for impaired loans that are collateral based is determined by reviewing real property appraisals, equipment valuations, accounts receivable listings and other financial information. A discounted cash flow analysis is performed to determine fair value for impaired loans when an observable market price or a current appraisal is not available. First Commonwealth s loan policy requires updated appraisals be obtained at

least every twelve months on all impaired loans with balances of $250 thousand and over.

The fair value for other real estate owned is determined by either an independent market based appraisal less estimated costs to sell or an executed sales agreement and is classified as Level 2. Other real estate owned has a book cost of $16.0 million as of September 30, 2012 and consisted primarily of a manufacturing plant in northern Pennsylvania, residential real estate in eastern Pennsylvania and a commercial real estate property in eastern Pennsylvania. During the first quarter of 2012, the sale of an office building in western Pennsylvania which was

FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 12 Fair Values of Assets and Liabilities (Continued)

previously in OREO for $6.8 million was completed and resulted in a $0.3 million loss at the time of sale. During the third quarter of 2012, a real estate property located in central Pennsylvania which was in OREO for $1.2 million was sold and resulted in a $0.6 million gain. We review whether events and circumstances subsequent to a transfer to other real estate owned have occurred that indicate the balance of those assets may not be recoverable. If events and circumstances indicate further impairment we will record a charge to the extent that the carrying value of the assets exceed their fair values, less estimated cost to sell, as determined by valuation techniques appropriate in the circumstances.

Certain other assets and liabilities, including goodwill and core deposit intangibles, are measured at fair value on a non-recurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments only in certain circumstances. Additional information related to goodwill is provided in Note 14, Goodwill. There were no other assets or liabilities measured at fair value on a non-recurring basis during the nine-months ended September 30, 2012.

FASB ASC 825-10, Transition Related to FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. The methodologies for estimating the fair value of financial assets and financial liabilities that are measured at fair value on a recurring or non-recurring basis are as discussed above. The methodologies for other financial assets and financial liabilities are discussed below.

Cash and due from banks and interest-bearing bank deposits: The carrying amounts for cash and due from banks and interest-bearing bank deposits approximate the estimated fair values of such assets.

Securities: Fair values for securities available for sale are based on quoted market prices, if available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments. Pooled trust preferred collateralized debt obligations values are derived from other valuation methodologies, including option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer or broker traded transactions. These valuations incorporate certain assumptions and projections in determining the fair value assigned to each instrument. The carrying value of other investments, which includes FHLB stock, is considered a reasonable estimate of fair value.

Loans held for sale: The fair value of loans held for sale is estimated utilizing a present value of future discounted cash flows of the loan utilizing a risk based expected return to discount the value unless a sales agreement has been executed, in which case the sales price would equal fair value.

Loans: The fair values of all loans are estimated by discounting the estimated future cash flows using interest rates currently offered for loans with similar terms to borrowers of similar credit quality adjusted for past due and nonperforming loans, which is not an exit price under FASB ASC Topic 820, Fair Value Measurements and Disclosures.

Off-balance sheet instruments: Many of First Commonwealth s off-balance sheet instruments, primarily loan commitments and standby letters of credit, are expected to expire without being drawn upon; therefore, the commitment amounts do not necessarily represent future cash requirements. FASB ASC Topic 460, Guarantees clarified that a guarantor is required to recognize, at the inception of a guarantee, a liability for the

FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 12 Fair Values of Assets and Liabilities (Continued)

fair value of the obligation undertaken in issuing the guarantee. The carrying amount and fair value for standby letters of credit was $0.2 million and $0.1 million at September 30, 2012 and December 31, 2011, respectively. See Note 6, Commitments and Contingent Liabilities, for additional information.

Deposit liabilities: Management estimates that the fair value of deposits is based on a market valuation of similar deposits. The carrying value of variable rate time deposit accounts and certificates of deposit approximate their fair values at the report date. Also, fair values of fixed rate time deposits for both periods are estimated by discounting the future cash flows using interest rates currently being offered and a schedule of aggregated expected maturities.

Short-term borrowings: The fair values of borrowings from the FHLB were estimated based on the estimated incremental borrowing rate for similar types of borrowings. The carrying amounts of other short-term borrowings such as federal funds purchased and securities sold under agreement to repurchase were used to approximate fair value due to the short-term nature of the borrowings.

Long-term debt and subordinated debt: The fair value of long-term debt and subordinated debt is estimated by discounting the future cash flows using First Commonwealth s estimated incremental borrowing rate for similar types of borrowing arrangements.

The following table presents carrying amounts and fair values of First Commonwealth s financial instruments:

	September 30, 2012				
			Fair Value Measurements Using:		
	Carrying Amount	Total	Level 1	Level 2	Level 3
			(dollars in thousands)		
Financial assets					
Cash and due from banks	$ 85,183	$ 85,183	$ 85,183	$ 0	$ 0
Interest-bearing deposits	3,881	3,881	3,881	0	0
Securities available for sale	1,130,822	1,130,822	440	1,105,911	24,471
Other investments	32,479	32,479	0	32,479	0
Loans	4,214,299	4,269,822	0	59,241	4,210,581
Financial liabilities					
Deposits	4,494,434	4,435,555	0	4,435,555	0
Short-term borrowings	461,770	461,760	0	461,760	0
Long-term debt	74,721	77,470	0	77,470	0
Subordinated debt	105,750	76,995	0	0	76,995

FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 12 Fair Values of Assets and Liabilities (Continued)

	December 31, 2011	
	Carrying Amount	**Estimated Fair Value**
	(dollars in thousands)	
Financial assets		
Cash and due from banks	$ 74,967	$ 74,967
Interest-bearing deposits	3,511	3,511
Securities available for sale	1,142,776	1,142,776
Other investments	39,796	39,796
Loans held for sale	13,412	13,412
Loans	4,043,643	4,113,525
Financial liabilities		
Deposits	4,504,684	4,452,235
Short-term borrowings	312,777	312,777
Long-term debt	101,664	103,749
Subordinated debt	105,750	75,310

Note 13 Derivatives

First Commonwealth is a party to interest rate derivatives that are not designated as accounting hedges. These derivatives relate to interest rate swaps that First Commonwealth enters into with customers to allow customers to convert variable rate loans to a fixed rate. First Commonwealth pays interest to the customer at a floating rate on the notional amount and receives interest from the customer at a fixed rate for the same notional amount. At the same time the interest rate swap is entered into with the customer, an offsetting interest rate swap is entered into with another financial institution. First Commonwealth pays the other financial institution interest at the same fixed rate on the same notional amount as the swap entered into with the customer, and receives interest from the financial institution for the same floating rate on the same notional amount. The changes in the fair value of the swaps offset each other, except for the credit risk of the counterparties, which is determined by taking into consideration the risk rating, probability of default and loss of given default for all counterparties.

We have twelve risk participation agreements with financial institution counterparties for interest rate swaps related to loans in which we are a participant. The risk participation agreements provide credit protection to the financial institution should the borrower fail to perform on its interest rate derivative contract with the financial institution.

The fee received, less the estimate of the loss for the credit exposure, was recognized in earnings at the time of the transaction.

The following table depicts the credit value adjustment recorded related to the notional amount of derivatives outstanding as well as the notional amount of risk participation agreements participated to other banks:

	September 30, 2012	**December 31, 2011**
	(dollars in thousands)	
Credit value adjustment	$ (1,836)	$ (2,963)
Notional Amount:		
Interest rate derivatives	207,822	187,368

Risk participation agreements	86,980	128,098
Sold credit protection on risk participation agreements	0	(22,147)

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 1. *Financial Statements and Supplementary Data (Continued)*

Notes to the Unaudited Condensed Consolidated Financial Statements (Continued)

Note 13 Derivatives (Continued)

The table below presents the amount representing the change in the fair value of derivative assets and derivative liabilities attributable to credit risk included in other income on the Condensed Consolidated Statements of Income:

	For the Three-Months Ended September 30,		For the Nine-Months Ended September 30,	
	2012	2011	2012	2011
	(dollars in thousands)			
Non-hedging interest rate derivatives:				
Increase (decrease) in other income	$ 375	$ (5,108)	$ 1,126	$ (5,643)

During 2012, total credit risk income of $1.3 million was recognized, offset by $0.2 million in expense related to three interest rate swaps that were downgraded during the third quarter to a below investment grade rating. As a result of the deterioration of credit risk related to the counterparty, a larger mark-to-market adjustment was recorded. The fair value of our derivatives is included in a table in Note 12 Fair Values of Assets and Liabilities, in the line items other assets and other liabilities.

Note 14 Goodwill

FASB ASC Topic 350-20, Intangibles Goodwill and Other requires an annual valuation of the fair value of a reporting unit that has goodwill and a comparison of the fair value to the book value of equity to determine whether the goodwill has been impaired. Goodwill is also required to be tested on an interim basis if an event or circumstance indicates that it is more likely than not that an impairment loss has been incurred. When triggering events or circumstances indicate goodwill testing is required, an assessment of qualitative factors can be completed before performing the two step goodwill impairment test. ASU 2011-08 provides that if an assessment of qualitative factors determines it is more likely than not that the fair value of a reporting unit exceeds its carrying amount, then the two step goodwill impairment test is not required.

First Commonwealth is considered to be one reporting unit. The carrying amount of goodwill as of September 30, 2012 and December 31, 2011 was $159.9 million. No impairment charges on goodwill or other intangible assets were incurred in 2012 or 2011.

We test goodwill for impairment as of November 30th each year and again at any quarter-end if any material events occur during a quarter that may affect goodwill. An assessment of qualitative factors was completed as of September 30, 2012 and indicated that it is more likely than not that the fair value of First Commonwealth exceeds its carrying amount, therefore the two step goodwill impairment test was not considered necessary. The assessment of qualitative factors incorporated the results of the step 2 goodwill impairment test completed as of December 31, 2011 as well as macroeconomic factors, industry and market considerations, the company s overall financial performance, and other company specific events occurring during the first nine months of 2012.

As of September 30, 2012, goodwill was not considered impaired; however, changing economic conditions that may adversely affect our performance, fair value of our assets and liabilities, or stock price could result in impairment, which could adversely affect earnings in future periods. Management will continue to monitor events that could impact this conclusion in the future.

FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. *Management s Discussion and Analysis of Financial Condition and*

Results of Operations

This discussion and the related financial data are presented to assist in the understanding and evaluation of the consolidated financial condition and the results of operations of First Commonwealth Financial Corporation including its subsidiaries (First Commonwealth) for the nine-months ended September 30, 2012 and 2011, and should be read in conjunction with the Condensed Consolidated Financial Statements and notes thereto included in this Form 10-Q.

Forward-Looking Statements

Certain statements contained in this report that are not historical facts may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), and are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements, which are based on certain assumptions and describe our future plans, strategies and expectations, can generally be identified by the use of words such as may, will, should, could, would, plan, believe, expect, anticipate, intend, estimate or words of similar meani forward-looking statements are subject to significant risks, assumptions and uncertainties, and could be affected by many factors. The following list, which is not intended to be an all-encompassing list of risks and uncertainties affecting us, summarizes several factors that could cause our actual results to differ materially from those anticipated or expected in these forward-looking statements:

continued weakness in economic and business conditions, both nationally and in our markets, which could cause deterioration in credit quality, a further reduction in demand for credit and/or a further decline in real estate values;

prolonged low interest rates, which could reduce our net interest margin;

increases in defaults by borrowers and other delinquencies, which could result in increases in our provision for credit losses and related expenses;

further declines in the market value of investment securities that are considered to be other-than-temporary, which would negatively impact our earnings and capital levels;

cyber-attacks and fraud, which could disrupt our systems and services, breach the privacy of our customer and business information or result in loss of client assets;

further declines in the valuations of real estate, which could negatively affect the creditworthiness of our borrowers and the value of collateral securing our loans;

the assumptions used in calculating the appropriate amount to be placed into our allowance for credit losses may prove to be inaccurate;

restrictions or conditions imposed by our regulators on our operations may make it more difficult for us to achieve our goals;

legislative and regulatory changes, including the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act and related regulations, subject us to additional regulatory oversight which may result in increased compliance costs and/or require us to change our business model;

changes in accounting standards and compliance requirements may have an adverse affect on our operating results and financial condition;

competitive pressures among depository and other financial institutions, some of which may have greater financial resources or more attractive product or service offerings, may adversely affect growth or profitability of our products and services; and

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. *Management s Discussion and Analysis of Financial Condition and*

Results of Operations (Continued)

Forward-Looking Statements (Continued)

other risks and uncertainties described in this report and in the other reports that we file with the Securities and Exchange Commission, including our most recent Annual Report on Form 10-K.

In light of these risks, uncertainties and assumptions, you should not place undue reliance on any forward-looking statements in this report. We undertake no obligation to publicly update or otherwise revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Explanation of Use of Non-GAAP Financial Measure

In addition to the results of operations presented in accordance with generally accepted accounting principles (GAAP), First Commonwealth management uses, and this quarterly report contains or references, certain non-GAAP financial measures, such as net interest income on a fully taxable equivalent basis. We believe this non-GAAP financial measure provides information useful to investors in understanding our underlying operational performance and our business and performance trends as it facilitates comparison with the performance of others in the financial services industry. Although we believe that this non-GAAP financial measure enhances investors understanding of our business and performance, this non-GAAP financial measure should not be considered an alternative to GAAP.

We believe the presentation of net interest income on a fully taxable equivalent basis ensures comparability of net interest income arising from both taxable and tax-exempt sources and is consistent with industry practice. Interest income per the Condensed Consolidated Statements of Income is reconciled to net interest income adjusted to a fully taxable equivalent basis on page 46 for the nine-months ended September 30, 2012 and 2011.

Results of Operations

Nine-Months Ended September 30, 2012 Compared to Nine-Months Ended September 30, 2011

Net Income

For the nine-months ended September 30, 2012, First Commonwealth had net income of $33.2 million, or $0.32 per share, compared to net income of $21.0 million or $0.20 per share in the nine-months ended September 30, 2011. The increase in net income is primarily the result of a lower provision for credit losses, receipt of a joint venture termination fee, positive market value adjustments for interest rate swaps and higher gains recognized on the sale of assets. These increases were offset by lower net security gains, increased salaries and employee benefit expenses and operational losses.

Net Interest Income

Net interest income, on a fully taxable equivalent basis, was $145.1 million in the first nine months of 2012 compared to $146.5 million for the same period in 2011. Net interest income comprises a majority of our operating revenue (net interest income before the provision plus noninterest income) at 73% and 77% for the nine-months ended September 30, 2012 and 2011, respectively.

Net interest margin, on a fully taxable equivalent basis, was 3.63% for the nine-months ended September 30, 2012 compared to 3.81% for the nine-months ended September 30, 2011. The net interest margin is affected by both changes in the level of interest rates and the amount and composition of interest-earning assets and interest-bearing liabilities.

FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. *Management s Discussion and Analysis of Financial Condition and*

Results of Operations (Continued)

Results of Operations (Continued)

Net Interest Income (Continued)

During the nine-months ended September 30, 2012, the net interest margin has been challenged by the continuing low interest rate environment and decreasing rates earned on interest-earning assets. Despite a disciplined approach to pricing which has provided for maintaining the level of new volume spreads, runoff of existing assets which are earning higher interest rates has continued to provide for lower yields on earning assets. Growth in earning assets has helped to offset the impact of runoff, as average earning assets for the nine months ended September 30, 2012 increased $202.6 million, or 4%, compared to the comparable period in 2011. It is expected that the challenges to the net interest margin will continue as $2.9 billion in interest-sensitive assets either reprice or mature over the next twelve months.

The taxable equivalent yield on interest-earning assets was 4.22% for the nine-months ended September 30, 2012, a decrease of 45 basis points from the 4.67% yield for the same period in 2011. This decline can be attributed to the repricing of our variable rate assets in a declining rate environment as well as lower interest rates available on new investments and loans. Reductions in the cost of interest-bearing liabilities partially offset the impact of lower yields on interest-earning assets. The cost of interest-bearing liabilities was 0.73% for the nine-months ended September 30, 2012, compared to 1.04% for the same period in 2011. Also, impacting the net interest margin in the first nine months of 2012 was the recognition of $1.2 million in interest income related to loans that were previously in nonaccrual status. This contributed 3 basis points to the net interest margin for the nine-months ended September 30, 2012. Offsetting this contribution was the reversal of $0.7 million, or 2 basis points, of interest income related to loans that were placed in nonaccrual status during 2012.

Comparing the nine-months ended September 30, 2012 with the same period in 2011, changes in interest rates negatively impacted net interest income by $10.1 million. The lower yield on interest-earning assets adversely impacted net interest income by $17.3 million, while the decline in the cost of interest-bearing liabilities had a positive impact of $7.2 million. We have been able to partially mitigate the impact of lower interest rates and the effect on net interest income through improving the mix of deposit and borrowed funds, disciplined pricing strategies, loan growth and increasing our investment volumes within established interest rate risk management guidelines.

While decreases in interest rates and yields compressed the net interest rate, increases in average interest-earning assets and low cost average interest-bearing liabilities neutralized the effect on net interest income. Changes in the volumes of interest-earning assets and interest-bearing liabilities positively impacted net interest income by $8.7 million in the nine-months ended September 30, 2012 compared to the same period in 2011. Higher levels of interest-earning assets resulted in an increase of $6.5 million in interest income, while volume changes primarily attributed to the mix of deposits reduced interest expense by $2.2 million.

Positively affecting net interest income was a $92.8 million increase in average net free funds at September 30, 2012 as compared to September 30, 2011. Average net free funds are the excess of noninterest-bearing demand deposits, other noninterest-bearing liabilities and shareholders equity over noninterest-earning assets. The largest component of the increase in net free funds was an increase in noninterest-bearing demand deposit average balances as a result of marketing promotions aimed at attracting new and retaining existing customers. Additionally, higher costing time deposits continue to runoff and reprice to lower costing certificates or other deposit alternatives. Average time deposits for the nine months ended September 30, 2012 decreased $229.2 million, or 17%, compared to the comparable period in 2011. The positive change in deposit mix is expected to continue as $589.5 million in certificates of deposits either mature or reprice over the next twelve months.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. *Management s Discussion and Analysis of Financial Condition and*

Results of Operations (Continued)

Results of Operations (Continued)

Net Interest Income (Continued)

The following table reconciles interest income in the Condensed Consolidated Statements of Income to net interest income adjusted to a fully taxable equivalent basis for the nine-months ended September 30:

	2012	2011
	(dollars in thousands)	
Interest income per Condensed Consolidated Statements of Income	$ 165,208	$ 175,058
Adjustment to fully taxable equivalent basis	3,361	4,227
Interest income adjusted to fully taxable equivalent basis (non-GAAP)	168,569	179,285
Interest expense	23,470	32,824
Net interest income adjusted to fully taxable equivalent basis (non-GAAP)	$ 145,099	$ 146,461

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. *Management s Discussion and Analysis of Financial Condition and*

Results of Operations (Continued)

Results of Operations (Continued)

Net Interest Income (Continued)

The following is an analysis of the average balance sheets and net interest income on a fully taxable equivalent basis, for the nine-months ended September 30:

	2012			2011		
	Average Balance	Income / Expense (a)	Yield or Rate	Average Balance	Income / Expense (a)	Yield or Rate
	(dollars in thousands)					
Assets						
Interest-earning assets:						
Interest-bearing deposits with banks	$ 4,458	$ 4	0.12%	$ 34,060	$ 63	0.25%
Tax-free investment securities	333	17	6.82	6,331	320	6.76
Taxable investment securities	1,184,948	24,406	2.75	1,021,795	25,416	3.33
Loans, net of unearned income (b)(c)	4,148,937	144,142	4.64	4,073,871	153,486	5.04
Total interest-earning assets	5,338,676	168,569	4.22	5,136,057	179,285	4.67
Noninterest-earning assets:						
Cash	74,553			74,736		
Allowance for credit losses	(64,438)			(78,042)		
Other assets	583,768			592,277		
Total noninterest-earning assets	593,883			588,971		
Total Assets	$ 5,932,559			$ 5,725,028		
Liabilities and Shareholders Equity						
Interest-bearing liabilities:						
Interest-bearing demand deposits (d)	$ 643,396	$ 222	0.05%	$ 603,980	$ 392	0.09%
Savings deposits (d)	1,909,777	3,276	0.23	1,867,973	5,725	0.41
Time deposits	1,156,689	13,446	1.55	1,385,857	20,609	1.99
Short-term borrowings	414,451	817	0.26	166,094	551	0.44
Long-term debt	190,720	5,709	4.00	181,261	5,547	4.09
Total interest-bearing liabilities	4,315,033	23,470	0.73	4,205,165	32,824	1.04

Noninterest-bearing liabilities and shareholders equity:

Noninterest-bearing demand deposits (d)	795,443			709,536		
Other liabilities	51,627			48,775		
Shareholders equity	770,456			761,552		
Total noninterest-bearing funding sources	1,617,526			1,519,863		
Total Liabilities and Shareholders Equity	$ 5,932,559			$ 5,725,028		
Net Interest Income and Net Yield on Interest-Earning Assets		$ 145,099	3.63%		$ 146,461	3.81%

(a) Income on interest-earning assets has been computed on a fully taxable equivalent basis using the 35% federal income tax statutory rate.

(b) Income on nonaccrual loans is accounted for on the cash basis, and the loan balances are included in interest-earning assets.

(c) Loan income includes loan fees earned.

(d) Average balances do not include reallocations from noninterest-bearing demand deposits and interest-bearing demand deposits into savings deposits, which were made for regulatory purposes.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. *Management s Discussion and Analysis of Financial Condition and*

Results of Operations (Continued)

Results of Operations (Continued)

Net Interest Income (Continued)

The following table shows the effect of changes in volumes and rates on interest income and interest expense for the nine-months ended September 30, 2012 compared with September 30, 2011:

	Analysis of Year-to-Year Changes in Net Interest Income		
	Total Change	**Change Due To Volume**	**Change Due To Rate (a)**
		(dollars in thousands)	
Interest-earning assets:			
Interest-bearing deposits with banks	$ (59)	$ (55)	$ (4)
Tax-free investment securities	(303)	(303)	0
Taxable investment securities	(1,010)	4,064	(5,074)
Loans	(9,344)	2,830	(12,174)
Total interest income (b)	(10,716)	6,536	(17,252)
Interest-bearing liabilities:			
Interest-bearing demand deposits	(170)	27	(197)
Savings deposits	(2,449)	128	(2,577)
Time deposits	(7,163)	(3,411)	(3,752)
Short-term borrowings	266	817	(551)
Long-term debt	162	289	(127)
Total interest expense	(9,354)	(2,150)	(7,204)
Net interest income	$ (1,362)	$ 8,686	$ (10,048)

(a) Changes in interest income or expense not arising solely as a result of volume or rate variances are allocated to rate variances.
(b) Changes in interest income have been computed on a fully taxable equivalent basis using the 35% federal income tax statutory rate.

Provision for Credit Losses

The provision for credit losses is determined based on management s estimates of the appropriate level of allowance for credit losses needed to absorb probable losses inherent in the loan portfolio, after giving consideration to charge-offs and recoveries for the period. The provision for credit losses is an amount added to the allowance against which credit losses are charged.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. *Management s Discussion and Analysis of Financial Condition and*

Results of Operations (Continued)

Results of Operations (Continued)

Provision for Credit Losses (Continued)

The table below provides a breakout of the provision for credit losses by loan category for the nine-months ended September 30:

	2012		2011	
	Dollars	Percentage	Dollars	Percentage
	(dollars in thousands)			
Commercial, financial, agricultural and other	$ 4,470	30%	$ 196	1%
Real estate construction	4,341	29	11,984	40
Residential real estate	1,120	8	3,770	12
Commercial real estate	1,855	12	12,443	42
Loans to individuals	2,074	14	1,708	6
Unallocated	978	7	(197)	(1)
Total	$ 14,838	100%	$ 29,904	100%

The provision for credit losses for the nine-months ended September 30, 2012 decreased in comparison to the nine-months ended September 30, 2011, by $15.1 million or 50%. The provision for credit losses for the nine-months ended September 30, 2012, was slightly more than the $12.0 million in net credit losses for the period.

During the nine-months ended September 30, 2012, the most significant provision for credit losses related to a $3.3 million increase in specific reserves for a commercial real estate loan. The resulting increase in provision for that loan category was partially offset by the impact of lower outstanding commercial real estate loans. The provision for credit losses for commercial, financial, agricultural and real estate construction categories can be attributed primarily to growth in those portfolios. The $1.0 million unallocated provision for credit losses is a result of management s analysis of certain qualitative factors impacting the reserve for credit losses and concern over the impact of the continued difficult economic conditions being experienced by our borrowers. This analysis included factors related primarily to portfolio risk and the impact of economic conditions on our portfolio.

The allowance for credit losses was $64.1 million, or 1.52%, of total loans outstanding at September 30, 2012, compared to $61.2 million, or 1.51%, at December 31, 2011 and $72.1 million, or 1.81%, at September 30, 2011. The decline from 1.81% at September 30, 2011, can be attributed to a $131.0 million, or 33%, decline in criticized loans, which encompasses the $68.0 million, or 42%, decrease in nonperforming loans. Nonperforming loans as a percentage of total loans decreased to 2.23% at September 30, 2012 from 2.76% at December 31, 2011 and 4.07% as of September 30, 2011. The allowance to nonperforming loan ratio was 68%, 62% and 45% as of September 30, 2012, December 31, 2011, and September 30, 2011, respectively. Improvement in these ratios contributed to the lower level of provision for credit losses for the nine-months ended September 30, 2012.

Net credit losses were $12.0 million in the nine-months ended September 30, 2012 compared to $29.0 million for the same period in 2011. The most significant credit losses recognized during the nine-months ended September 30, 2012, were a $1.4 million partial charge-off of a construction loan for a Florida condominium project and a $1.2 million partial charge-off of a commercial borrower in the shallow gas well business. Net credit losses during the nine-month period did not include any other significant individual charge-offs.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. *Management s Discussion and Analysis of Financial Condition and*

Results of Operations (Continued)

Results of Operations (Continued)

Provision for Credit Losses (Continued)

Below is an analysis of the consolidated allowance for credit losses for the nine-months ended September 30, 2012 and 2011 and the year-ended December 31, 2011:

	September 30, 2012	**September 30, 2011**	**December 31, 2011**
		(dollars in thousands)	
Balance, beginning of period	$ 61,234	$ 71,229	$ 71,229
Loans charged off:			
Commercial, financial, agricultural and other	4,939	3,642	7,114
Real estate construction	2,356	14,570	28,886
Residential real estate	2,984	2,686	4,107
Commercial real estate	638	6,918	24,861
Loans to individuals	2,494	2,332	3,325
Total loans charged off	13,411	30,148	68,293
Recoveries of loans previously charged off:			
Commercial, financial, agricultural and other	349	335	473
Real estate construction	121	0	955
Residential real estate	331	118	132
Commercial real estate	256	239	349
Loans to individuals	396	440	573
Total recoveries	1,453	1,132	2,482
Net credit losses	11,958	29,016	65,811
Provision charged to expense	14,838	29,904	55,816
Balance, end of period	$ 64,114	$ 72,117	$ 61,234

Noninterest Income

The following table presents the components of noninterest income for the nine-months ended September 30:

	2012	2011	$ Change	% Change
		(dollars in thousands)		
Noninterest Income:				
Trust income	$ 4,780	$ 5,085	$ (305)	(6)%
Service charges on deposit accounts	10,975	11,010	(35)	0
Insurance and retail brokerage commissions	4,938	4,876	62	1
Income from bank owned life insurance	4,369	4,158	211	5
Card related interchange income	9,659	8,895	764	9
Other income	10,222	3,710	6,512	176
Subtotal	44,943	37,734	7,209	19
Net securities gains	163	2,185	(2,022)	(93)
Gain on sale of assets	4,316	2,272	2,044	90
Joint venture termination fee	1,909	0	1,909	N/A
Total noninterest income	$ 51,331	$ 42,191	$ 9,140	22%

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. *Management s Discussion and Analysis of Financial Condition and*

Results of Operations (Continued)

Results of Operations (Continued)

Noninterest Income (Continued)

Noninterest income, excluding net securities gains, gain on sale of assets and the joint venture termination fee, increased $7.2 million, or 19%, for the first nine months of 2012 compared to 2011. The most notable change in this total is the $6.5 million increase in the other income category. This increase is primarily the result of $1.1 million of income recognized in relation to the mark-to-market adjustment on interest rate derivatives during the first nine months of 2012 while a $5.6 million decline in income was recognized during the same period in 2011, as the result of an adverse mark-to-market adjustment related to credit deterioration for one commercial relationship. The increase in the mark-to-market adjustment recognized between the two periods is due to the change in the credit default curves over time as well as a change in counterparty credit risk related to the interest rate swaps. In addition, $1.0 million in swap fee income was earned during the nine-months ended September 30, 2012, while only $0.4 million was earned during the same period of 2011. The fees earned on these swaps are based on the notional value of the initiated contracts. In comparison, eleven swaps with a notional value of $111.5 million were entered into during 2012, while six swaps with a notional value of $32.6 million were entered into during the same period in 2011.

Total noninterest income increased $9.1 million in comparison to the nine-months ended September 30, 2011. The most significant changes in noninterest income, in addition to the aforementioned changes were a $2.0 million increase in gain on sale of assets and the receipt of a $1.9 million joint venture termination fee. The increase in gain on sale of assets is primarily the result of the sale of three loans transferred to held for sale in the fourth quarter of 2011. The sales of these loans were completed in March, April, and June of 2012 and resulted in a $2.9 million gain. The $1.9 million termination fee relates to the dissolution of a mortgage banking joint venture with another financial institution. As a result, the Company is exploring other strategic options related to the origination of residential mortgages. Offsetting these increases was a $2.0 million decrease in net security gains, primarily due to a $1.5 million gain recognized in 2011 from the sale of an equity security.

Noninterest Expense

The following table presents the components of noninterest expense for the nine-months ended September 30:

	2012	2011	$ Change	% Change
		(dollars in thousands)		
Noninterest Expense:				
Salaries and employee benefits	$ 65,401	$ 63,092	$ 2,309	4%
Net occupancy expense	9,942	10,733	(791)	(7)
Furniture and equipment expense	9,326	9,407	(81)	(1)
Data processing expense	5,346	4,482	864	19
Pennsylvania shares tax expense	4,203	4,046	157	4
Intangible amortization	1,109	1,163	(54)	(5)
Collection and repossession expense	4,650	5,003	(353)	(7)
Other professional fees and services	3,167	3,930	(763)	(19)
FDIC insurance	3,757	4,260	(503)	(12)
Other operating expenses	18,216	17,052	1,164	7

Subtotal	125,117	123,168	1,949	2
Loss on sale or write-down of assets	4,215	4,674	(459)	(10)
Operational losses	4,033	408	3,625	888
Total noninterest expense	$ 133,365	$ 128,250	$ 5,115	4%

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Results of Operations (Continued)

Noninterest Expense (Continued)

The 2012 increase in noninterest expense is largely attributable to expenses incurred in relation to salary and incentives paid to employees for developing customer relationships and originating loans as well as a $3.5 million operational loss.

During the third quarter of 2012, the Company experienced a $3.5 million operational loss due to an external fraud. The full amount of the loss has been recognized and an insurance claim, with up to a $0.5 million deductible, has been filed. The outcome of that claim has not been determined, therefore a receivable has not been recognized. In addition, various recovery strategies are currently being pursued.

Salary and employee benefits expense reflects an increase compared to the same period of 2011 primarily due to normal merit increases, the hiring of additional business development professionals and higher levels of employee incentives as a result of increased loan and deposit volumes. New loans originated during the nine-months ended September 30, 2012 totaled $1.0 billion compared to $626.7 million in the same period of 2011. The number of full-time equivalent employees decreased 67 positions from 1,479 at September 30, 2011 to 1,412 at September 30, 2012.

FDIC insurance expense decreased due to the favorable effects of changes made by the FDIC in its assessment methodology effective April 1, 2011.

Other expense increased primarily due to the unfunded commitment reserve recognized during the period. The unfunded commitment reserve is based on a calculation using outstanding commitments at period end, expected loss and expected usage. During the nine-months ended September 30, 2012, this expense was impacted by increased commitments and changes in expected utilization rates resulting in the recognition of $0.6 million in expense, while $0.6 million reversal of expense was recognized for the same period in 2011.

Income Tax

The provision for income taxes increased $6.4 million for the nine-months ended September 30, 2012, compared to the corresponding period in 2011. The higher provision for income taxes was primarily due to the increase in net income before tax of $18.6 million.

We applied the annual effective tax rate approach to determine the provision for income taxes, which applies an annual forecast of tax expense as a percentage of expected full year income for the nine-months ended September 30, 2012 and 2011.

We generate an annual effective tax rate that is less than the statutory rate of 35% due to benefits resulting from tax-exempt interest, income from bank owned life insurance and tax benefits associated with low income housing tax credits, which are relatively consistent regardless of the level of pretax income. The level of tax benefits that reduce our tax rate below the 35% statutory rate produced an annual effective tax rate of 26.0% and 20.1% for the nine-months ended September 30, 2012 and 2011, respectively.

As of September 30, 2012, our deferred tax assets totaled $62.2 million. Based on our evaluation as of September 30, 2012, we determined that it is more likely than not that all of these assets will be realized. As a result, we did not record a valuation allowance against these assets. In evaluating the need for a valuation

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Results of Operations (Continued)

Income Tax (Continued)

allowance, we estimate future taxable income based on management approved forecasts, evaluation of historical earning levels and consideration of potential tax strategies. If future events differ from our current forecasts, we may need to establish a valuation allowance, which could have a material impact on our financial condition and results of operations.

Three-Months Ended September 30, 2012 Compared to Three-Months Ended September 30, 2011

Net Income

For the three-months ended September 30, 2012, First Commonwealth had net income of $9.8 million, or $0.09 per share, compared to net income of $8.3 million or $0.08 per share in the three-months ended September 30, 2011. The increase in net income is primarily the result of lower collection and repossession expense and other professional fees, the receipt of a joint venture termination fee and improvements in the mark-to-market adjustments on interest rate swaps. Partially offsetting these performance factors were an increase in salaries and employee benefits and operational losses.

Net Interest Income

Net interest income, on a fully taxable equivalent basis, was $47.4 million in the third quarter of 2012 compared to $48.8 million for the same period in 2011. Net interest margin, on a fully taxable equivalent basis, was 3.54% for the three-months ended September 30, 2012 compared to 3.81% for the three-months ended September 30, 2011. The taxable equivalent yield on interest-earning assets was 4.08% for the three-months ended September 30, 2012, a decrease of 53 basis points from the 4.61% for the same period in 2011.

Comparing the three months ended September 30, 2012 with the same period in 2011, changes in interest rates negatively impacted net interest income by $5.1 million. The lower yield on interest-earning assets adversely impacted net interest income by $7.4 million, while the decline in the cost of interest-bearing liabilities had a positive impact of $2.3 million. The cost of interest-bearing liabilities was 0.67% for the three months ended September 30, 2012, compared to 0.97% for the same period in 2011. We have been able to partially mitigate the impact of lower interest rates and the effect on net interest income through improving the mix of deposit and borrowed funds, disciplined pricing strategies, loan growth and increasing our investment volumes within established interest rate risk management guidelines.

While decreases in interest rates and yields compressed the interest rate margin, increases in average interest-earning assets and low cost average interest-bearing liabilities neutralized the effect on net interest income. Changes in the volumes of interest-earning assets and interest-bearing liabilities positively impacted net interest income by $4.0 million in the three-months ended September 30, 2012 compared to the same period in 2011. Higher levels of interest-earning assets resulted in an increase of $3.5 million in interest income, while volume changes primarily attributed to the mix of deposits reduced interest expense by $0.5 million

Positively affecting net interest income was a $113.3 million increase in average net free funds at September 30, 2012 as compared to September 30, 2011.

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Results of Operations (Continued)

Net Interest Income (Continued)

The following table reconciles interest income in the Condensed Consolidated Statements of Income to net interest income adjusted to a fully taxable equivalent basis for the three-months ended September 30:

	For the Three Months Ended September 30,	
	2012	2011
	(dollars in thousands)	
Interest income per Condensed Consolidated Statements of Income	$ 53,880	$ 57,600
Adjustment to fully taxable equivalent basis	1,054	1,288
Interest income adjusted to fully taxable equivalent basis (non-GAAP)	54,934	58,888
Interest expense	7,230	10,120
Net interest income adjusted to fully taxable equivalent basis (non-GAAP)	$ 47,704	$ 48,768

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Results of Operations (Continued)

Net Interest Income (Continued)

The following is an analysis of the average balance sheets and net interest income on a fully taxable equivalent basis, for the three-months ended September 30:

	2012			2011		
	Average Balance	Income / Expense (a)	Yield or Rate	Average Balance	Income / Expense (a)	Yield or Rate
	(dollars in thousands)					
Assets						
Interest-earning assets:						
Interest-bearing deposits with banks	$ 6,193	$ 2	0.13%	$ 41,903	$ 27	0.26%
Tax-free investment securities	92	2	8.65	755	14	7.36
Taxable investment securities	1,169,191	7,538	2.56	1,037,103	8,455	3.23
Loans, net of unearned income (b)(c)	4,186,446	47,392	4.50	3,993,225	50,392	5.01
Total interest-earning assets	5,361,922	54,934	4.08	5,072,986	58,888	4.61
Noninterest-earning assets:						
Cash	75,512			77,206		
Allowance for credit losses	(64,902)			(78,033)		
Other assets	578,344			599,141		
Total noninterest-earning assets	588,954			598,314		
Total Assets	$ 5,950,876			$ 5,671,300		
Liabilities and Shareholders Equity						
Interest-bearing liabilities:						
Interest-bearing demand deposits (d)	$ 657,272	$ 64	0.04%	$ 610,570	$ 123	0.08%
Savings deposits (d)	1,872,828	977	0.21	1,868,885	1,796	0.38
Time deposits	1,101,991	4,013	1.45	1,296,831	6,178	1.89
Short-term borrowings	485,754	311	0.25	167,969	188	0.44
Long-term debt	181,038	1,865	4.10	179,033	1,835	4.07
Total interest-bearing liabilities	4,298,883	7,230	0.67	4,123,288	10,120	0.97

Noninterest-bearing liabilities and shareholders equity:

Noninterest-bearing demand deposits (d)	824,784			726,895		
Other liabilities	53,823			51,667		
Shareholders equity	773,386			769,450		
Total noninterest-bearing funding sources	1,651,993			1,548,012		
Total Liabilities and Shareholders Equity	$ 5,950,876			$ 5,671,300		
Net Interest Income and Net Yield on Interest-Earning Assets		$ 47,704	3.54%		$ 48,768	3.81%

(a) Income on interest-earning assets has been computed on a fully taxable equivalent basis using the 35% federal income tax statutory rate.

(b) Income on nonaccrual loans is accounted for on the cash basis, and the loan balances are included in interest-earning assets.

(c) Loan income includes loan fees earned.

(d) Average balances do not include reallocations from noninterest-bearing demand deposits and interest-bearing demand deposits into savings deposits, which were made for regulatory purposes.

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Results of Operations (Continued)

Results of Operations (Continued)

Net Interest Income (Continued)

The following table shows the effect of changes in volumes and rates on interest income and interest expense for the three-months ended September 30, 2012 compared with September 30, 2011:

	Analysis of Quarter-to-Quarter Changes in Net Interest Income		
	Total Change	**Change Due To Volume**	**Change Due To Rate (a)**
	(dollars in thousands)		
Interest-earning assets:			
Interest-bearing deposits with banks	$ (25)	$ (23)	$ (2)
Tax-free investment securities	(12)	(12)	0
Taxable investment securities	(917)	1,075	(1,992)
Loans	(3,000)	2,440	(5,440)
Total interest income (b)	(3,954)	3,480	(7,434)
Interest-bearing liabilities:			
Interest-bearing demand deposits	(59)	9	(68)
Savings deposits	(819)	4	(823)
Time deposits	(2,165)	(928)	(1,237)
Short-term borrowings	123	352	(229)
Long-term debt	30	21	9
Total interest expense	(2,890)	(542)	(2,348)
Net interest income	$ (1,064)	$ 4,022	$ (5,086)

(a) Changes in interest income or expense not arising solely as a result of volume or rate variances are allocated to rate variances.

(b) Changes in interest income have been computed on a fully taxable equivalent basis using the 35% federal income tax statutory rate.

Provision for Credit Losses

The provision for credit losses is determined based on management s estimates of the appropriate level of allowance for credit losses needed to absorb probable losses inherent in the loan portfolio, after giving consideration to charge-offs and recoveries for the period. The provision for credit losses is an amount added to the allowance against which credit losses are charged.

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Provision for Credit Losses (Continued)

The table below provides a breakout of the provision for credit losses by loan category for the three-months ended September 30:

	2012		2011	
	Dollars	**Percentage**	**Dollars**	**Percentage**
		(dollars in thousands)		
Commercial, financial, agricultural and other	$ (25)	0%	$ (3,975)	(57)%
Real estate construction	2,848	42	4,237	61
Residential real estate	566	8	750	11
Commercial real estate	2,823	42	5,165	73
Loans to individuals	635	9	820	12
Unallocated	(93)	(1)	(22)	0
Total	$ 6,754	100%	$ 6,975	100%

The provision for credit losses for the three-months ended September 30, 2012 decreased in comparison to the three-months ended September 30, 2011, by $0.2 million or 3%. The provision for credit losses for the three months ended September 30, 2012 related to the real estate construction category is primarily a result of $18.0 million in loan growth, all within Pennsylvania. The commercial real estate provision for credit losses for this period can be attributed to a $3.3 million specific reserve required for an impaired loan.

Net credit losses were $4.3 million in the three-months ended September 30, 2012 compared to $10.0 million for the same period in 2011. Net credit losses during the three-month period included a $1.4 million charge-off on a construction loan for a Florida condominium project.

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Provision for Credit Losses (Continued)

Below is an analysis of the consolidated allowance for credit losses for the three-months ended:

	September 30, 2012	June 30, 2012	September 30, 2011
		(dollars in thousands)	
Balance, beginning of period	$ 61,676(a)	$ 60,732(a)	$ 75,166(a)
Loans charged off:			
Commercial, financial, agricultural and other	1,271	1,754	685
Real estate construction	2,016	150	6,522
Residential real estate	530	742	986
Commercial real estate	97	306	1,343
Loans to individuals	756	797	810
Total loans charged off	4,670	3,749	10,346
Recoveries of loans previously charged off:			
Commercial, financial, agricultural and other	74	37	74
Real estate construction	29	36	0
Residential real estate	49	149	22
Commercial real estate	70	28	75
Loans to individuals	132	146	151
Total recoveries	354	396	322
Net credit losses	4,316	3,353	10,024
Provision charged to expense	6,754	4,297	6,975
Balance, end of period	$ 64,114	$ 61,676	$ 72,117

(a) The balance at the beginning of the period represents June 30, 2012, March 31, 2012 and June 30, 2011.

Noninterest Income

The following table presents the components of noninterest income for the three-months ended September 30:

	2012	2011	$ Change	% Change
		(dollars in thousands)		
Noninterest Income:				
Trust income	$ 1,631	$ 1,603	$ 28	2%
Service charges on deposit accounts	3,736	3,836	(100)	(3)
Insurance and retail brokerage commissions	1,844	1,698	146	9
Income from bank owned life insurance	1,465	1,411	54	4
Card related interchange income	3,260	3,053	207	7
Other income	3,090	(1,592)	4,682	(294)
Subtotal	15,026	10,009	5,017	50
Net securities gains	163	0	163	0
Gain on sale of assets	757	790	(33)	(4)
Joint venture termination fee	1,909	0	1,909	N/A
Total noninterest income	$ 17,855	$ 10,799	$ 7,056	65%

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Results of Operations (Continued)

Noninterest Income (Continued)

Noninterest income, excluding net securities gains, gain on sale of assets and a joint venture termination fee, increased $5.0 million or 50% for the third quarter of 2012 compared to 2011. During the three-months ended September 30, 2012, $0.4 million in income was recognized as the result of credit mark-to-market adjustments on interest rate swaps, while a $5.1 million loss was recorded in the same period in 2011.

Total noninterest income increased $7.1 million primarily due to a joint venture termination fee received during the period as well as the previously mentioned fair market value adjustments made in relation to interest rate swaps.

Noninterest Expense

The following table presents the components of noninterest expense for the three-months ended September 30:

	2012	2011	$ Change	% Change
		(dollars in thousands)		
Noninterest Expense:				
Salaries and employee benefits	$ 21,280	$ 20,418	$ 862	4%
Net occupancy expense	3,235	3,506	(271)	(8)
Furniture and equipment expense	3,118	3,092	26	1
Data processing expense	1,987	1,533	454	30
Pennsylvania shares tax expense	1,510	1,434	76	5
Intangible amortization	367	384	(17)	(4)
Collection and repossession expense	1,281	1,961	(680)	(35)
Other professional fees and services	1,028	1,706	(678)	(40)
FDIC insurance	1,258	1,177	81	7
Other operating expenses	5,618	5,565	53	1
Subtotal	40,682	40,776	(94)	0
Loss on sale or write-down of assets	426	159	267	168
Operational losses	3,657	186	3,471	1,866
Total noninterest expense	$ 44,765	$ 41,121	$ 3,644	9%

The 2012 increase in noninterest expense is largely attributable to a $3.5 million increase in operational losses resulting from the previously mentioned external fraud.

Salary and employee benefits expense reflects an increase compared to the third quarter of 2011 primarily due to normal merit increases, the hiring of additional business development professionals and a higher level of employee incentives as a result of increased loan and deposit volumes. New loans originated during the third quarter of 2012 totaled $275.2 million compared to $250.6 million in the third quarter of 2011.

Collection and repossession expense decreased when comparing third quarter 2012 to the same period in 2011, primarily as a result of expenses recognized in the prior period to maintain one OREO property.

Loss on sale or write-down of assets increased due to the write-down of two foreclosed properties; one was written down approximately $0.2 million due to an updated appraisal and the other was written down approximately $0.1 million as a result of a pending sales agreement.

FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

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Results of Operations (Continued)

Results of Operations (Continued)

Income Tax

The provision for income taxes increased $1.3 million for the three-months ended September 30, 2012, compared to the corresponding period in 2011. The higher provision for income taxes was primarily due to the increase in net income before tax of $2.8 million.

The level of tax benefits that reduce our tax rate below the 35% statutory rate produced an annual effective tax rate of 24.2% and 18.2% for the three-months ended September 30, 2012 and 2011, respectively.

Liquidity

Liquidity refers to our ability to meet the cash flow requirements of depositors and borrowers as well as our operating cash needs with cost-effective funding. We generate funds to meet these needs primarily through the core deposit base of First Commonwealth Bank and the maturity or repayment of loans and other interest-earning assets, including investments. During the first nine months of 2012, liquidity provided from the $149.0 million increase in short-term borrowings, the net decrease of $12.0 million in investment securities and the sale of $13.4 million in loans provided funds to originate loans. We also have available unused wholesale sources of liquidity, including overnight federal funds and repurchase agreements, advances from the FHLB of Pittsburgh, borrowings through the discount window at the Federal Reserve Bank (FRB) of Cleveland and access to certificates of deposit through brokers.

In order to increase and diversify our funding sources, we participate in the Certificate of Deposit Account Registry Services (CDARS) program as part of an Asset/Liability Committee (ALCO) strategy to increase and diversify funding sources. As of September 30, 2012, our maximum borrowing capacity under this program was $887.8 million and as of that date there was $89.0 million outstanding. We also participate in a reciprocal program which allows our depositors to receive expanded FDIC coverage by placing multiple certificates of deposit at other CDARS member banks. As of September 30, 2012, our outstanding certificates of deposits from this program have an average weighted rate of 0.25% and an average original term of 73 days.

An additional source of liquidity is the FRB Borrower-in-Custody of Collateral program which enables us to pledge certain loans, not being used as collateral at the FHLB, as collateral for borrowings at the FRB. At September 30, 2012, the borrowing capacity under this program totaled $821.3 million and there were no amounts outstanding.

As of September 30, 2012, our maximum borrowing capacity at the FHLB of Pittsburgh was $1.3 billion and as of that date amounts used against this capacity included $382.3 million in outstanding borrowings and $26.0 million in letter of credit commitments used for pledging public funds and other non-deposit purposes.

First Commonwealth Financial Corporation has an unsecured $15.0 million line of credit with another financial institution and as of September 30, 2012 there are no amounts outstanding on this line. Additionally, we guarantee a $0.1 million ESOP loan.

First Commonwealth s long-term liquidity source is its core deposit base. Core deposits are the most stable source of liquidity a bank can have due to the long-term relationship with a deposit customer. The level of deposits during any period is influenced by factors outside of management s control, such as the level of short-

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Results of Operations (Continued)

Liquidity (Continued)

term and long-term market interest rates and yields offered on competing investments, such as money market mutual funds. The following table shows a breakdown of the components of First Commonwealth s deposits:

	September 30, 2012	December 31, 2011
	(dollars in thousands)	
Noninterest-bearing demand deposits	$ 858,003	$ 780,377
Interest-bearing demand deposits	97,834	95,945
Savings deposits	2,433,065	2,430,802
Time deposits	1,105,532	1,197,560
Total	$ 4,494,434	$ 4,504,684

During the first nine months of 2012, total deposits decreased $10.3 million due to an $87.9 million decline in interest bearing deposits, offset by an increase of $77.6 million in noninterest bearing deposits. The decrease in interest-bearing deposits can be attributed to a decline in time deposit balances which reflects a continued preference by customers to maintain non-maturity deposits as a result of the low interest rate environment. Partially offsetting the decline in time deposits were increases in interest-bearing demand deposits and savings deposits as a result of successful marketing promotions aimed at attracting new and retaining existing customers.

Market Risk

The following gap analysis compares the difference between the amount of interest-earning assets and interest-bearing liabilities subject to repricing over a period of time. The ratio of rate sensitive assets to rate sensitive liabilities repricing within a one-year period was 0.79 at September 30, 2012 and 0.76 at December 31, 2011. A ratio of less than one indicates a higher level of repricing liabilities over repricing assets over the next twelve months.

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Market Risk (Continued)

Gap analysis has limitations due to the static nature of the model that holds volumes and consumer behaviors constant in all economic and interest rate scenarios. Rate sensitive assets to rate sensitive liabilities repricing in one year would indicate reduced net interest income in a rising interest rate scenario, and conversely, increased net interest income in a declining interest rate scenario. Following is the gap analysis as of September 30, 2012 and December 31, 2011:

	September 30, 2012					
	0-90 Days	**91-180 Days**	**181-365 Days**	**Cumulative 0-365 Days**	**Over 1 Year Through 5 Years**	**Over 5 Years**
			(dollars in thousands)			
Loans	$ 1,953,970	$ 187,164	$ 366,875	$ 2,508,009	$ 1,426,984	$ 192,576
Investments	162,606	84,179	157,771	404,556	470,333	282,270
Other interest-earning assets	3,881	0	0	3,881	0	0
Total interest-sensitive assets (ISA)	2,120,457	271,343	524,646	2,916,446	1,897,317	474,846
Certificates of Deposit	252,598	128,709	208,227	589,534	506,228	9,770
Other deposits	2,530,899	0	0	2,530,899	0	0
Borrowings	534,186	152	29,817	564,155	38,665	39,421
Total interest-sensitive liabilitites (ISL)	3,317,683	128,861	238,044	3,684,588	544,893	49,191
Gap	$ (1,197,226)	$ 142,482	$ 286,602	$ (768,142)	$ 1,352,424	$ 425,655
ISA/ISL	0.64	2.11	2.20	0.79	3.48	9.65
Gap/Total assets	20.08%	2.39%	4.81%	12.88%	22.68%	7.14%

	December 31, 2011					
	0-90 Days	**91-180 Days**	**181-365 Days**	**Cumulative 0-365 Days**	**Over 1 Year Through 5 Years**	**Over 5 Years**
			(dollars in thousands)			
Loans	$ 1,859,623	$ 156,447	$ 287,873	$ 2,303,943	$ 1,486,729	$ 174,495
Investments	125,112	107,723	205,335	438,170	418,413	320,739
Other interest-earning assets	3,511	0	0	3,511	0	0
Total interest-sensitive assets (ISA)	1,988,246	264,170	493,208	2,745,624	1,905,142	495,234
Certificates of Deposit	154,218	192,154	323,085	669,457	517,572	10,531
Other deposits	2,526,747	0	0	2,526,747	0	0
Borrowings	386,683	25,147	299	412,129	68,334	39,728

Total interest-sensitive liabilitites (ISL)	3,067,648	217,301	323,384	3,608,333	585,906	50,259
Gap	$ (1,079,402)	$ 46,869	$ 169,824	$ (862,709)	$ 1,319,236	$ 444,975
ISA/ISL	0.65	1.22	1.53	0.76	3.25	9.85
Gap/Total assets	18.48%	0.80%	2.91%	14.77%	22.59%	7.62%

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. *Management s Discussion and Analysis of Financial Condition and*

Results of Operations (Continued)

Market Risk (Continued)

The following table presents an analysis of the potential sensitivity of our annual net interest income to gradual changes in interest rates over a 12 month time frame versus if rates remained unchanged utilizing a flat balance sheet.

	Net interest income change (12 months)			
	-200	-100	+100	+200
	(dollars in thousands)			
September 30, 2012	$ (7,005)	$ (4,126)	$ 46	$ 1,356
December 31, 2011	(7,787)	(3,997)	704	2,324

The analysis and model used to quantify the sensitivity of our net interest income becomes less reliable in a decreasing 200 basis point scenario given the current low interest rate environment. Results of the 100 and 200 basis point decline in interest rate scenario are affected by the fact that many of our interest-bearing liabilities are at rates below 1% and therefore cannot decline 100 or 200 basis points, yet our interest-sensitive assets are able to decline by these amounts. In the nine-month period ended September 30, 2012 and 2011, the cost of our interest-bearing liabilities averaged 0.73% and 1.04%, respectively, and the yield on our average interest-earning assets, on a fully taxable equivalent basis, averaged 4.22% and 4.67%, respectively.

The ALCO is responsible for the identification and management of interest rate risk exposure. As such, the ALCO continuously evaluates strategies to manage our exposure to interest rate fluctuations.

Asset/liability models require certain assumptions be made, such as prepayment rates on earning assets and pricing impact on non-maturity deposits, which may differ from actual experience. These business assumptions are based upon our experience, business plans and published industry experience. While management believes such assumptions to be reasonable, there can be no assurance that modeled results will approximate actual results.

Credit Risk

First Commonwealth maintains an allowance for credit losses at a level deemed sufficient to absorb losses inherent in the loan portfolio at the date of each statement of financial condition. Management reviews the adequacy of the allowance on a quarterly basis to ensure that the provision for credit losses has been charged against earnings in an amount necessary to maintain the allowance at a level that is appropriate based on management s assessment of probable estimated losses.

First Commonwealth s methodology for assessing the appropriateness of the allowance for credit losses consists of several key elements. These elements include an assessment of individual impaired loans with a balance greater than $0.1 million, loss experience trends, delinquency and other relevant factors. While allocations are made to specific loans and pools of loans, the total allowance is available for all loan losses.

Nonperforming loans include nonaccrual loans and loans classified as troubled debt restructurings. Nonaccrual loans represent loans on which interest accruals have been discontinued. Troubled debt restructured loans are those loans whose terms have been renegotiated to provide a reduction or deferral of principal or interest as a result of the deteriorating financial position of the borrower, who could not obtain comparable terms from alternative financing sources. In the first half of 2012, nine relationships totaling $10.3 million were identified as troubled debt restructuring. Please refer to Note 10 Loans and Allowance for Credit Losses for additional information on troubled debt restructuring.

FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. *Management s Discussion and Analysis of Financial Condition and*

Results of Operations (Continued)

Credit Risk (Continued)

We discontinue interest accruals on a loan when, based on current information and events, it is probable that we will be unable to fully collect principal or interest due according to the contractual terms of the loan. A loan is also placed in nonaccrual status when, based on regulatory definitions, the loan is maintained on a cash basis due to the weakened financial condition of the borrower. Generally, loans 90 days or more past due are placed on nonaccrual status, except for consumer loans which are placed in nonaccrual status at 150 days past due. In the third quarter, the Company decided to place all loans 150 days or more past due on nonaccrual status. In periods prior to the third quarter of 2012, if a consumer loan was well secured and in the process of collection, it remained on accrual status, despite delinquency.

Nonperforming loans are closely monitored on an ongoing basis as part of our loan review and work-out process. The probable risk of loss on these loans is evaluated by comparing the loan balance to the fair value of any underlying collateral or the present value of projected future cash flows. Losses or specifically assigned allowance for loan losses are recognized where appropriate.

The allowance for credit losses was $64.1 million at September 30, 2012 or 1.52% of total loans outstanding compared to 1.51% reported at December 31, 2011 and 1.81% at September 30, 2011. The stability in the September 30, 2012 ratio when compared to December 31, 2011 can be primarily attributable to a $0.3 million decrease in specific reserves resulting from a $4.8 million decrease in nonperforming loans, excluding loans held for sale and $170.7 million in loan growth, particularly in commercial loans. Complementing the decrease in nonaccrual loans is improvement in other credits measures. The level of criticized loans decreased as of September 30, 2012 when compared to December 31, 2011, by $23.0 million, or 8% and delinquency on accruing loans for the same period declined $10.2 million, or 29%.

The allowance for credit losses as a percentage of nonperforming loans was 68% as of September 30, 2012 compared to 62% at December 31, 2011 and 45% at September 30, 2011. The amount of allowance related to nonperforming loans was determined by using fair values obtained from current appraisals and updated discounted cash flow analyses. The allowance for credit losses includes specific allocations of $12.9 million related to nonperforming loans covering 14% of the total nonperforming balance. Management believes that the allowance for credit losses is at a level deemed sufficient to absorb losses inherent in the loan portfolio at September 30, 2012.

FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. *Management s Discussion and Analysis of Financial Condition and*

Results of Operations (Continued)

Credit Risk (Continued)

The following table provides information related to nonperforming assets, the allowance for credit losses and other credit-related measures:

	September 30,		December 31,
	2012	2011	2011
		(dollars in thousands)	
Nonperforming Loans:			
Loans on nonaccrual basis	$ 40,704	$ 127,384(c)	$ 33,635
Loans held for sale on a nonaccrual basis	0	0	13,412
Troubled debt restructured loans on nonaccrual basis	46,026	0	44,841
Troubled debt restructured loans on accrual basis	7,176	34,500	20,276
Total nonperforming loans	$ 93,906	$ 161,884	$ 112,164
Loans past due in excess of 90 days and still accruing	$ 2,998	$ 12,566	$ 11,015
Other real estate owned	$ 16,016	$ 33,254	$ 30,035
Loans outstanding at end of period	$ 4,214,299	$ 3,973,723	$ 4,057,055
Average loans outstanding	$ 4,148,937(a)	$ 4,073,871(a)	$ 4,061,822(b)
Nonperforming loans as a percentage of total loans	2.23%	4.07%	2.76%
Provision for credit losses	$ 14,838(a)	$ 29,904(a)	$ 55,816(b)
Allowance for credit losses	$ 64,114	$ 72,117	$ 61,234
Net charge-offs	$ 11,958(a)	$ 29,016(a)	$ 65,811(b)
Net charge-offs as a percentage of averge loans outstanding (annualized)	0.38%	0.95%	1.62%
Provision for credit losses as a percentage of net charge-offs	124.08%(a)	103.06%(a)	84.81%(b)
Allowance for credit losses as a percentage of end-of-period loans outstanding (c)	1.52%	1.81%	1.51%
Allowance for credit losses as a percentage of nonperforming loans (c)	68.27%	44.55%	62.01%

(a) For the three-month period ended.
(b) For the twelve-month period ended.
(c) End of period loans and nonperforming loans exclude loans held for sale.

During the nine-months ended September 30, 2012, accruing troubled debt restructured loans decreased $13.1 million from December 31, 2011. During the first quarter of 2012, an $11.3 million loan to a waste management company in Pennsylvania paid off due to the sale of the business. In addition, a $2.2 million loan to a retail development company in western Pennsylvania paid off during the first quarter.

FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. *Management s Discussion and Analysis of Financial Condition and*

Results of Operations (Continued)

Credit Risk (Continued)

The following tables show the outstanding balances of our loan portfolio and the breakdown of net charge-offs and nonperforming loans by loan type as of and for the periods presented:

	September 30, 2012		December 31, 2011	
	Amount	%	Amount	%
	(dollars in thousands)			
Commercial, financial, agricultural and other	$ 1,087,019	26%	$ 996,739	25%
Real estate construction	95,425	2	76,564	2
Residential real estate	1,228,328	29	1,137,059	28
Commercial real estate	1,217,249	29	1,267,432	31
Loans to individuals	586,278	14	565,849	14
Total loans and leases net of unearned income	$ 4,214,299	100%	$ 4,043,643	100%

	For the nine-months ending September 30, 2012			As of September 30, 2012		
	Net Charge-offs	% of Total Net Charge-offs	Net Charge-offs as a % of Average Loans	Nonperforming Loans (a)	% of Total Nonperforming Loans	Nonperforming Loans as a % of Total Loans
	(dollars in thousands)					
Commercial, financial, agricultural and other	$ 4,590	38.39%	0.14%	$ 33,481	35.65%	0.80%
Real estate construction	2,235	18.69	0.07	11,569	12.32	0.28
Residential real estate	2,653	22.19	0.09	9,839	10.48	0.23
Commercial real estate	382	3.19	0.01	38,933	41.46	0.92
Loans to individuals	2,098	17.54	0.07	84	0.09	0.00
Total loans, net of unearned income	$ 11,958	100.00%	0.38%	$ 93,906	100.00%	2.23%

As the above table illustrates, three categories of loans commercial, financial, agricultural and other, real estate construction and commercial real estate were a significant portion of the nonperforming loans as of September 30, 2012. See discussions related to the provision for credit losses and loans for more information.

Capital Resources

At September 30, 2012, shareholders equity was $773.9 million, an increase of $15.3 million from December 31, 2011. The increase was primarily the result of $33.2 million net income offset by $13.6 million of dividends paid to shareholders. Additionally, other comprehensive income increased $3.0 million due to changes in the fair value of available for sale investments and unearned ESOP shares decreased $1.5

million. Cash dividends declared per common share were $0.13 and $0.09 for the nine-months ended September 30, 2012 and 2011, respectively.

First Commonwealth is 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 First Commonwealth s financial statements. Under capital adequacy guidelines and the regulatory framework for

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. *Management s Discussion and Analysis of Financial Condition and*

Results of Operations (Continued)

Capital Resources (Continued)

prompt corrective action, First Commonwealth and its banking subsidiary must meet specific capital guidelines that involve quantitative measures of First Commonwealth s assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. First Commonwealth s capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weighting and other factors.

Quantitative measures established by regulation to ensure capital adequacy require First Commonwealth to maintain minimum amounts and ratios of Total and Tier I capital (common and certain other core equity capital) to risk weighted assets, and of Tier I capital to average assets. As of September 30, 2012, First Commonwealth and its banking subsidiary met all capital adequacy requirements to which they are subject.

The table below presents First Commonwealth s capital position at September 30, 2012.

	Actual		Regulatory Minumum		Well Capitalized Regulatory	
	Capital Amount	Ratio	Capital Amount	Ratio	Capital Amount	Ratio
	(dollars in thousands)					
Total Capital to Risk Weighted Assets						
First Commonwealth Financial Corporation	$ 732,744	14.9%	$ 392,510	8.0%		
First Commonwealth Bank	701,114	14.3	391,527	8.0	$ 489,409	10.0%
Tier I Capital to Risk Weighted Assets						
First Commonwealth Financial Corporation	$ 671,354	13.7%	$ 196,255	4.0%		
First Commonwealth Bank	639,876	13.1	195,764	4.0	$ 293,645	6.0%
Tier I Capital to Average Assets						
First Commonwealth Financial Corporation	$ 671,354	11.7%	$ 229,809	4.0%		
First Commonwealth Bank	639,876	11.2	228,145	4.0	$ 285,182	5.0%

On June 19, 2012, the company announced a $50 million common stock repurchase program effective until December 31, 2012. As of September 30, 2012, 1,341,900 shares were repurchased at an average price of $6.79 per share.

On October 24, 2012, First Commonwealth Financial Corporation declared a quarterly dividend of $0.05 per share payable on November 16, 2012 to shareholders of record as of November 5, 2012.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 3. *Quantitative and Qualitative Disclosures About Market Risk*

Information appearing in Item 2 of this report under the caption Market Risk is incorporated by reference in response to this item.

ITEM 4. *Controls and Procedures*

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report pursuant to Rule 13a-15 under the Securities Exchange Act of 1934 (the Exchange Act). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to provide reasonable assurance that the information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in applicable rules and forms of the Securities and Exchange Commission.

In addition, our management, including our Chief Executive Officer and Chief Financial Officer, also conducted an evaluation of our internal controls over financial reporting to determine whether any changes occurred during the current fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting. No such changes were identified in connection with this evaluation.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

PART II OTHER INFORMATION

ITEM 1. **LEGAL PROCEEDINGS**

The information required by this Item is set forth in the Legal proceedings section in Part I, Item 1, Note 6 Commitments and Contingent Liabilities which is incorporated herein by reference in response to this item.

ITEM 1A. **RISK FACTORS**

For a discussion of certain risk factors affecting the Company, see Part I, Item 1A: Risk Factors of the Company s Annual Report on Form 10-K for the year ended December 31, 2011, and Forward-Looking Statements on page 43 of this Form 10-Q. There were no material changes to the risk factors described above other than the following:

Acts of cyber-crime may compromise client and company information, disrupt access to our systems or result in loss of client or company assets.

Our business is dependent upon the availability of technology, the Internet and telecommunication systems to enable financial transactions by clients, record and monitor transactions and transmit and receive data to and from clients and third parties. Information security risks have increased significantly due to the use of online, telephone and mobile banking channels by clients and the increased sophistication and activities of organized crime, hackers, terrorists and other external parties. Our technologies, systems, networks and our clients devices have been subject to, and are likely to continue to be the target of, cyber-attacks, computer viruses, malicious code, phishing attacks or information security breaches that could result in the unauthorized release, gathering, monitoring, misuse, loss or destruction of our or our clients confidential, proprietary and other information, the theft of client assets through fraudulent transactions or disruption of our or our clients or other third parties business operations.

During the quarter ending September 30, 2012, we incurred a $3.5 million charge in connection with fraudulent wire transfers involving the breach of a commercial client s computer system to gain access to our online banking system. There was no breach of First Commonwealth s systems, however, following this incident, we have enhanced our monitoring and security procedures to help prevent and mitigate the risk of fraudulent transfers. However, there can be no assurance that we will not incur fraud losses in the future.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

PART II OTHER INFORMATION

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On June 19, 2012, the Company announced a share repurchase program through which the Board of Directors authorized management to repurchase up to $50.0 million of the Company s common stock. At the close price of $6.22 on June 18, 2012, the authorized program represents approximately 8.0 million shares of common stock. The following table details the amount of shares repurchased under this program during the third quarter of 2012:

Month Ending:	Total Number of Shares Purchased	Average Price Paid per Share (or Unit)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs*
July 31, 2012	0	$ 0.00	0	6,756,172
August 31, 2012	872,817	6.95	872,200	5,875,339
September 30, 2012	0	0.00	0	5,800,335
Total	872,817	$ 6.95	872,200	

* Remaining number of shares approved under the Plan is estimated based on the market value of the Company s common stock of $7.01 at July 31, 2012, $6.96 at August 31, 2012 and $7.05 at September 30, 2012.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

None

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

PART II OTHER INFORMATION

ITEM 6. EXHIBITS

Exhibit Number	Description	Incorporated by Reference to
31.1	Chief Executive Officer Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
31.2	Chief Financial Officer Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
32.1	Chief Executive Officer Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed herewith
32.2	Chief Financial Officer Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed herewith
101	Interactive Data File (XBRL)	Furnished herewith

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SIGNATURES

Pursuant to the requirements 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.

FIRST COMMONWEALTH FINANCIAL CORPORATION

(Registrant)

DATED: November 8, 2012	/s/ T. Michael Price T. Michael Price President and Chief Executive Officer
DATED: November 8, 2012	/s/ Robert E. Rout Robert E. Rout Executive Vice President and Chief Financial Officer

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