

FIRST COMMONWEALTH FINANCIAL CORP /PA/
Form 10-K
March 13, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K

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

For the fiscal year ended December 31, 2012

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 001-11138

FIRST COMMONWEALTH FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

PENNSYLVANIA

(State or other jurisdiction of incorporation or organization)

25-1428528

(I.R.S. Employer Identification No.)

601 PHILADELPHIA STREET INDIANA, PA

(Address of principal executive offices)

15701

(Zip Code)

Registrant's telephone number, including area code: (724) 349-7220

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

Title of each class

COMMON STOCK, \$1 PAR VALUE

Name of each exchange on which registered

NEW YORK STOCK EXCHANGE

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

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

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Note Checking the box above will not relieve any registrant required to file reports pursuant to Section 13 or 15(d) of the Exchange Act from their obligations under those Sections.

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

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

The aggregate market value of the voting and non-voting common stock, par value \$1 per share, held by non-affiliates of the registrant (based upon the closing sale price on June 30, 2012) was approximately \$696,275,402.

The number of shares outstanding of the registrant's common stock, \$1.00 Par Value as of March 7, 2013, was 99,298,120.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be filed with the Securities and Exchange Commission in connection with the annual meeting of shareholders to be held April 23, 2013 are incorporated by reference into Part III.

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FIRST COMMONWEALTH FINANCIAL CORPORATION AND SUBSIDIARIES

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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, and are intended to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements include, among others, statements regarding our strategy, evaluations of our asset quality, future interest rate trends and liquidity, prospects for growth in assets and prospects for future operating results. Forward-looking statements can generally be identified by the use of words such as believe, expect, anticipate, intend, plan, estimate or words of similar meaning, or future or conditional verbs such as will, would, should, could or Forward-looking statements are based on assumptions of management and are only expectations of future results. You should not place undue reliance on our forward-looking statements. Our actual results could differ materially from those projected in the forward-looking statements as a result of, among others, the risk factors described in Item 1A of this report. Forward-looking statements speak only as of the date on which they are made. We do not undertake any obligation to update any forward-looking statement to reflect circumstances or events that occur after the date the forward-looking statements are made.

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ITEM 1. Business

Overview

First Commonwealth Financial Corporation (First Commonwealth or we) is a financial holding company that is headquartered in Indiana, Pennsylvania. We provide a diversified array of consumer and commercial banking services through our bank subsidiary, First Commonwealth Bank (FCB or the Bank). We also provide trust and wealth management services and offer insurance products through FCB and our other operating subsidiaries. At December 31, 2012, we had total assets of \$6.0 billion, total loans of \$4.2 billion, total deposits of \$4.6 billion and shareholders' equity of \$746.0 million. Our principal executive office is located at 601 Philadelphia Street, Indiana, Pennsylvania 15701, and our telephone number is (724) 349-7220.

FCB is a Pennsylvania bank and trust company. At December 31, 2012, the Bank operated 112 community banking offices throughout western and central Pennsylvania and a loan production office in downtown Pittsburgh, Pennsylvania. The largest concentration of our branch offices is located within the greater Pittsburgh metropolitan area in Allegheny, Butler, Washington and Westmoreland counties, while our remaining offices are located in smaller cities, such as Altoona, Johnstown, and Indiana, Pennsylvania, and in towns and villages throughout predominantly rural counties. The Bank also operates a network of 120 automated teller machines, or ATMs, at various branch offices and offsite locations. All of our ATMs are part of the NYCE and MasterCard/Cirrus networks, both of which operate nationwide. The Bank is a member of the Allpoint ATM network which allows surcharge-free access to over 50,000 ATMs. The Bank is also a member of the Freedom ATM Alliance, which affords cardholders surcharge-free access to a network of over 700 ATMs in over 50 counties in Pennsylvania, Maryland, New York, West Virginia and Ohio.

Historical and Recent Developments

FCB began in 1934 as First National Bank of Indiana with initial capitalization of \$255 thousand. First National Bank of Indiana changed its name to National Bank of the Commonwealth in 1971 and became a subsidiary of First Commonwealth in 1983.

Since the formation of the holding company in 1983, we have grown steadily through the acquisition of smaller banks and thrifts in our market area, including Deposit Bank in 1984, Dale National Bank and First National Bank of Leechburg in 1985, Citizens National Bank of Windber in 1986, Peoples Bank and Trust Company in 1990, Central Bank in 1992, Peoples Bank of Western Pennsylvania in 1993, Unitas National Bank and Reliable Savings Bank in 1994. In 1995, we merged all of our banking subsidiaries (other than Reliable Savings Bank) into Deposit Bank and renamed the resulting institution First Commonwealth Bank. We then merged Reliable Savings Bank into FCB in 1997. We acquired Southwest Bank in 1998 and merged it into FCB in 2002.

In the fourth quarter of 2003, we acquired Pittsburgh Financial Corp., the holding company for Pittsburgh Savings Bank (dba BankPittsburgh), for a total cost of approximately \$28.6 million. Pittsburgh Financial had total assets of approximately \$376.4 million, with 7 branch offices and one loan production office in Allegheny and Butler counties of Pennsylvania. In the second quarter of 2004, we acquired GA Financial, Inc., the holding company for Great American Federal, for a total cost of approximately \$176.7 million. GA Financial, Inc. had total assets of approximately \$890.3 million, with 12 branch offices located in Allegheny County. In the third quarter of 2006, we acquired Laurel Capital Group, Inc. (Laurel), the holding company for Laurel Savings Bank, for a total cost of approximately \$56.1 million. Laurel had total assets of approximately \$314.3 million, with 8 branch offices located in Allegheny and Butler Counties.

In recent years, we have primarily focused on organic growth, improving the reach of our franchise and the breadth of our product offering. As part of this strategy, we have opened fourteen de novo branches since 2005, all of which are in the greater Pittsburgh area. As a result of our acquisition and de novo strategy, FCB operates 49 branches in the Pittsburgh metropolitan statistical area and currently ranks ninth in deposit market share.

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ITEM 1. Business (Continued)

Competition

The banking and financial services industry is extremely competitive in our market area. We face vigorous competition for customers, loans and deposits from many companies, including commercial banks, savings and loan associations, finance companies, credit unions, trust companies, mortgage companies, money market mutual funds, insurance companies, and brokerage and investment firms. Many of these competitors are significantly larger than us, have greater resources, lending limits and larger branch systems and offer a wider array of financial services than us. In addition, some of these competitors, such as credit unions, are subject to a lesser degree of regulation than that imposed on us.

Employees

At December 31, 2012, First Commonwealth and its subsidiaries employed 1,289 full-time employees and 193 part-time employees.

Supervision and Regulation

The following discussion sets forth the material elements of the regulatory framework applicable to financial holding companies and their subsidiaries and provides certain specific information relevant to First Commonwealth and its subsidiaries. The regulatory framework is intended primarily for the protection of depositors, other customers and the federal deposit insurance fund and not for the protection of security holders. The rules governing the regulation of financial institutions and their holding companies are very detailed and technical. Accordingly, the following discussion is general in nature and is not intended to be complete or to describe all the laws and regulations that apply to First Commonwealth and its subsidiaries. A change in applicable statutes, regulations or regulatory policy may have a material adverse effect on our business, financial condition or results of operations.

Regulatory Reforms

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which was enacted in July 2010, significantly restructures the financial regulatory regime in the United States. Although the Dodd-Frank Act 's provisions that have received the most public attention generally have been those applying to or more likely to affect larger institutions such as bank holding companies with total consolidated assets of \$50 billion or more, it contains numerous other provisions that affect all bank holding companies and banks, including First Commonwealth and FCB, some of which are described in more detail below.

Many of the Dodd-Frank Act 's provisions are subject to final rulemaking by the U.S. financial regulatory agencies, and the implications of the Dodd-Frank Act for First Commonwealth 's businesses will depend to a large extent on how such rules are adopted and implemented by the primary U.S. financial regulatory agencies. First Commonwealth continues to analyze the impact of rules adopted under Dodd-Frank, on its businesses. However, the full impact will not be known until the rules, and other regulatory initiatives that overlap with the rules, are finalized and their combined impacts can be understood.

Bank Holding Company Regulation

First Commonwealth is registered as a financial holding company under the Bank Holding Company Act of 1956, as amended (BHC Act), and is subject to supervision and regulation by the Board of Governors of the Federal Reserve System (FRB).

Acquisitions. Under the BHC Act, First Commonwealth is required to obtain the prior approval of the FRB before it can merge or consolidate with any other bank holding company or acquire all or substantially all of the assets of any bank that is not already majority owned by it or acquire direct or indirect ownership, or control of,

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ITEM 1. Business (Continued) Supervision and Regulation (Continued)

Bank Holding Company Regulation (Continued)

any voting shares of any bank that is not already majority owned by it, if after such acquisition it would directly or indirectly own or control more than 5% of the voting shares of such bank. Satisfactory financial condition, particularly with regard to capital adequacy, and satisfactory Community Reinvestment Act (CRA) ratings are generally prerequisites to obtaining federal regulatory approval to make acquisitions and open branch offices.

Non-Banking Activities. First Commonwealth is generally prohibited under the BHC Act from engaging in, or acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company engaged in non-banking activities unless the FRB, by order or regulation, has found such activities to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. In making this determination, the FRB considers whether the performance of these activities by a bank holding company can reasonably be expected to produce benefits to the public that outweigh the possible adverse effects.

Reporting. Under the BHC Act, First Commonwealth is subject to examination by the FRB and is required to file periodic reports and other information of its operations with the FRB. In addition, under the Pennsylvania Banking Code of 1965, the Pennsylvania Department of Banking has the authority to examine the books, records and affairs of any Pennsylvania bank holding company or to require any documentation deemed necessary to ensure compliance with the Pennsylvania Banking Code.

Source of Strength Doctrine. FRB policy has historically required bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) codifies this policy as a statutory requirement. Under this requirement, First Commonwealth is expected to commit resources to support FCB, including at times when First Commonwealth may not be in a financial position to provide such resources. Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary banks. In the event of a bank holding company s bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to priority of payment.

Affiliate Transactions. Transactions between FCB, on the one hand, and First Commonwealth and its other subsidiaries, on the other hand, are regulated by the Federal Reserve Board. These regulations limit the types and amounts of covered transactions engaged in by FCB and generally require those transactions to be on an arm s-length basis. Covered transactions are defined by statute to include a loan or extension of credit, as well as a purchase of securities issued by an affiliate, a purchase of assets (unless otherwise exempted by the Federal Reserve Board) from the affiliate, certain derivative transactions that create a credit exposure to an affiliate, the acceptance of securities issued by the affiliate as collateral for a loan, and the issuance of a guarantee, acceptance or letter of credit on behalf of an affiliate. In general, these regulations require that any such transaction by FCB (or its subsidiaries) with an affiliate must be secured by designated amounts of specified collateral and must be limited to certain thresholds on an individual and aggregate basis.

SEC Regulations. First Commonwealth is also under the jurisdiction of the Securities and Exchange Commission (SEC) and various state securities commissions for matters relating to the offer and sale of its securities and is subject to the SEC rules and regulations relating to periodic reporting, proxy solicitation and insider trading.

Bank Regulations

FCB is a state bank chartered under the Pennsylvania Banking Code and is not a member of the FRB. As such, FCB is subject to the supervision of, and is regularly examined by, both the Federal Deposit Insurance Corporation (FDIC) and the Pennsylvania Department of Banking and is required to furnish quarterly reports

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ITEM 1. Business (Continued) Supervision and Regulation (Continued)

Bank Regulations (Continued)

to both agencies. The approval of the Pennsylvania Department of Banking and FDIC is also required for FCB to establish additional branch offices or merge with or acquire another banking institution.

Restrictions on Dividends. The Pennsylvania Banking Code states, in part, that dividends may be declared and paid only out of accumulated net earnings and may not be declared or paid unless surplus is at least equal to capital. Dividends may not reduce surplus without the prior consent of the Pennsylvania Department of Banking. FCB has not reduced its surplus through the payment of dividends.

The FDIC also prohibits the declaration or payout of dividends at a time when FCB is in default in payment of any assessment due the FDIC. In addition, supervisory guidance issued by the FRB requires, among other things, that a company must consult with the FRB in advance of paying a dividend that exceeds earnings for the quarter for which the dividend is paid or that could result in a material adverse change to the company's capital structure. The guidance also states that a company should, as a general matter, eliminate, defer or severely limit its dividend if (1) the company's net income for the past four quarters, net of dividends paid during that period, is not sufficient to fully fund the dividend; (2) the company's prospective rate of earnings retention is not consistent with the company's capital needs and current and prospective financial condition; or (3) the company will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

Community Reinvestment. Under the Community Reinvestment Act, or CRA, a bank has a continuing and affirmative obligation, consistent with its safe and sound operation, to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the CRA. The CRA requires the applicable regulatory agency to assess an institution's record of meeting the credit needs of its community. The CRA requires public disclosure of an institution's CRA rating and requires that the applicable regulatory agency provide a written evaluation of an institution's CRA performance utilizing a four-tiered descriptive rating system. An institution's CRA rating is considered in determining whether to grant charters, branches and other deposit facilities, relocations, mergers, consolidations and acquisitions. Performance less than satisfactory may be the basis for denying an application. For its most recent examination, FCB received a satisfactory rating.

Consumer Protection Laws. The operations of FCB are also subject to numerous federal, state and local consumer protection laws and regulations including the Truth in Lending Act, Truth in Savings Act, Equal Credit Opportunity Act, Fair Housing Act, Real Estate Settlement Procedures Act and Home Mortgage Disclosure Act. Among other things, these acts:

require banks to disclose credit terms in meaningful and consistent ways;

prohibit discrimination against an applicant in any consumer or business credit transaction;

prohibit discrimination in housing-related lending activities;

require banks to collect and report applicant and borrower data regarding loans for home purchases or improvement projects;

require lenders to provide borrowers with information regarding the nature and cost of real estate settlements;

prohibit certain lending practices and limit escrow account amounts with respect to real estate transactions; and

prescribe possible penalties for violations of the requirements of consumer protection statutes and regulations.

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ITEM 1. Business (Continued) Supervision and Regulation (Continued)

Bank Regulations (Continued)

Deposit Insurance. Deposits of FCB are insured up to applicable limits by the FDIC and are subject to deposit insurance assessments to maintain the Deposit Insurance Fund (DIF). Deposit insurance assessments are based upon average total assets minus average total equity. The insurance assessments are based upon a matrix that takes into account a bank's capital level and supervisory rating. The FDIC may terminate deposit insurance upon a finding that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC.

In November 2009, the FDIC issued a rule that required all insured depository institutions, with limited exceptions, to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. As of December 31, 2012, \$9.2 million in pre-paid deposit insurance is included in other assets in the accompanying Statements of Financial Condition.

In October 2010, the FDIC adopted a new DIF restoration plan to ensure that the fund reserve ratio reaches 1.35% by September 30, 2020, as required by the Dodd-Frank Act. At least semi-annually, the FDIC will update its loss and income projections for the fund and, if needed, will increase or decrease assessment rates, following notice-and-comment rulemaking if required.

The separate deposit insurance coverage for non-interest-bearing transaction accounts that became effective on December 31, 2010 terminated on December 31, 2012.

Capital Requirements

As a bank holding company, we are subject to consolidated regulatory capital requirements administered by the FRB. FCB is subject to similar capital requirements administered by the FDIC and the Pennsylvania Department of Banking. The federal regulatory authorities' risk-based capital guidelines are based upon the 1988 capital accord (Basel I) of the Basel Committee on Banking Supervision (the Basel Committee). The Basel Committee is a committee of central banks and bank supervisors/regulators from the major industrialized countries that develops broad policy guidelines for use by each country's supervisors in determining the supervisory policies they apply. The requirements are intended to ensure that banking organizations have adequate capital given the risk levels of assets and off-balance sheet financial instruments. Under the requirements, banking organizations are required to maintain minimum ratios for Tier 1 capital and total capital to risk-weighted assets (including certain off-balance sheet items, such as letters of credit). For purposes of calculating the ratios, a banking organization's assets and some of its specified off-balance sheet commitments and obligations are assigned to various risk categories.

A depository institution's or holding company's capital, in turn, is classified in one of three tiers, depending on type:

Core Capital (Tier 1). Tier 1 capital includes common equity, retained earnings, qualifying non-cumulative perpetual preferred stock, a limited amount of qualifying cumulative perpetual stock at the holding company level, minority interests in equity accounts of consolidated subsidiaries, and qualifying trust preferred securities, less goodwill, most intangible assets and certain other assets.

Supplementary Capital (Tier 2). Tier 2 capital includes, among other things, perpetual preferred stock and trust preferred securities not meeting the Tier 1 definition, qualifying mandatory convertible debt securities, qualifying subordinated debt, and allowances for possible loan and lease losses, subject to limitations.

Market Risk Capital (Tier 3). Tier 3 capital includes qualifying unsecured subordinated debt.

Table of Contents**ITEM 1. Business (Continued)
Supervision and Regulation (Continued)****Capital Requirements (Continued)**

First Commonwealth, like other bank holding companies, currently is required to maintain Tier 1 capital and total capital (the sum of Tier 1 and Tier 2 capital) equal to at least 4.0% and 8.0%, respectively, of its total risk-weighted assets (including various off-balance sheet items, such as letters of credit). FCB, like other depository institutions, is required to maintain similar capital levels under capital adequacy guidelines. In addition, for a depository institution to be considered well capitalized under the regulatory framework for prompt corrective action, its Tier 1 and total capital ratios must be at least 6.0% and 10.0% on a risk-adjusted basis, respectively.

Bank holding companies and banks are also required to comply with minimum leverage ratio requirements. The leverage ratio is the ratio of a banking organization's Tier 1 capital to its total adjusted quarterly average assets (as defined for regulatory purposes). The minimum leverage ratio is 3.0% for bank holding companies and depository institutions that either have the highest supervisory rating or have implemented the appropriate federal regulatory authority's risk-adjusted measure for market risk. All other bank holding companies and depository institutions are required to maintain a minimum leverage ratio of 4.0%, unless a different minimum is specified by an appropriate regulatory authority. In addition, for a depository institution to be considered well capitalized under the regulatory framework for prompt corrective action, its leverage ratio must be at least 5.0%.

As of December 31, 2012, FCB was a well-capitalized bank as defined by the FDIC. See Note 28 Regulatory Restrictions and Capital Adequacy of Notes to the Consolidated Financial Statements, contained in Item 8, for a table that provides a comparison of First Commonwealth's and FCB's risk-based capital ratios and the leverage ratio to minimum regulatory requirements.

In June 2012, the FRB published two notices of proposed rulemaking (the 2012 Capital Proposals) that would substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions compared to the current U.S. risk-based capital rules, which are based on the aforementioned Basel I capital accords of the Basel Committee. One of the 2012 Capital Proposals (the Basel III Proposal) addresses the components of capital and other issues affecting the numerator in banking institutions' regulatory capital ratios and would implement the Basel Committee's December 2010 framework known as Basel III for strengthening international capital standards. The other proposal (the Standardized Approach Proposal) addresses risk weights and other issues affecting the denominator in banking institutions' regulatory capital ratios and would replace the existing Basel I-derived risk-weighting approach with a more risk-sensitive approach based, in part, on the standardized approach in the Basel Committee's 2004 Basel II capital accords. The 2012 Capital Proposals would also implement the requirements of Section 939A of the Dodd-Frank Act to remove references to credit ratings from the federal banking agencies' rules. As proposed, the Basel III Proposal and the Standardized Approach Proposal would come into effect on January 1, 2013 (subject to a phase-in period) and January 1, 2015 (with an option for early adoption), respectively; however, final rules have not yet been adopted, and the Basel III framework is therefore not yet applicable to First Commonwealth or FCB.

The Basel III Proposal, among other things: (1) introduces a new capital measure called Common Equity Tier 1, (2) specifies that Tier 1 capital consist of Common Equity Tier 1 and Additional Tier 1 capital instruments meeting specified requirements, (3) defines Common Equity Tier 1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to Common Equity Tier 1 and not to the other components of capital and (4) expands the scope of the deductions/adjustments as compared to existing regulations.

When fully phased in on January 1, 2019, the Basel III Proposal will require First Commonwealth and FCB to maintain (1) a minimum ratio of Common Equity Tier 1 to risk-weighted assets of at least 4.5%, plus a 2.5% capital conservation buffer (which is added to the 4.5% Common Equity Tier 1 ratio as that buffer is phased in,

Table of Contents**ITEM 1. Business (Continued)**
Supervision and Regulation (Continued)*Capital Requirements* (Continued)

effectively resulting in a minimum ratio of Common Equity Tier 1 to risk-weighted assets of at least 7% upon full implementation), (2) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (3) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (4) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets.

The Basel III Proposal also provides for a countercyclical capital buffer over and above the capital conservation buffer that is designed to absorb losses during periods of economic stress. The countercyclical capital buffer is applicable to only certain covered institutions and is not expected to have any current applicability to First Commonwealth or FCB.

The Basel III Proposal provides for a number of deductions from and adjustments to Common Equity Tier 1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from Common Equity Tier 1 to the extent that any one such category exceeds 10% of Common Equity Tier 1 or all such categories in the aggregate exceed 15% of Common Equity Tier 1. Under current capital standards, the effects of accumulated other comprehensive income items included in capital are excluded for the purposes of determining regulatory capital ratios. Under the Basel III Proposal, the effects of certain accumulated other comprehensive items are not excluded, which could result in significant variations in the level of capital depending upon the impact of interest rate fluctuations on the fair value of First Commonwealth's securities portfolio. The Basel III Proposal also requires the phase-out of certain hybrid securities, such as trust preferred securities, as Tier 1 capital of bank holding companies. Trust preferred securities no longer included in Tier 1 capital may nonetheless be included as a component of Tier 2 capital. Implementation of the deductions and other adjustments to Common Equity Tier 1 will begin on January 1, 2014 and will be phased-in over a five-year period (20% per year). The implementation of the capital conservation buffer will begin on January 1, 2016 at the 0.625% level and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

The Standardized Approach Proposal would expand the risk-weighting categories from the current four Basel I-derived categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, depending on the nature of the assets, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures, and resulting in higher risk weights for a variety of asset categories, including many residential mortgages and certain commercial real estate. Among other things, the Standardized Approach Proposal would:

Apply a 150% risk weight instead of a 100% risk weight for certain high volatility commercial real estate acquisition, development and construction loans.

Revise risk weightings for residential mortgage exposures to replace the current approach of a 50% risk weight for high-quality seasoned mortgages and a 100% risk-weight for all other mortgages with a risk weight of between 35% and 200% depending upon the mortgage's loan-to-value ratio and whether the mortgage is a category 1 or category 2 residential mortgage exposure (based on eight criteria that include the term, use of negative amortization, balloon payments and certain rate increases).

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ITEM 1. Business (Continued) Supervision and Regulation (Continued)

Capital Requirements (Continued)

Assign a 150% risk weight to exposures (other than residential mortgage exposures) that are 90 days past due.

Provide for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (currently set at 0%).

Provide for a risk weight, generally not less than 20% with certain exceptions, for securities lending transactions based on the risk weight category of the underlying collateral securing the transaction.

Eliminate the current 50% cap on the risk weight for over-the-counter derivatives.

In addition, the Standardized Approach Proposal also provides more advantageous risk weights for derivatives and repurchase-style transactions cleared through a qualifying central counterparty and increases the scope of eligible guarantors and eligible collateral for purposes of credit risk mitigation.

Management believes that, as of December 31, 2012, First Commonwealth and FCB would meet all capital adequacy requirements under the Basel III and Standardized Approach Proposals on a fully phased-in basis if such requirements were currently effective. There can be no guarantee that the Basel III and the Standardized Approach Proposals will be adopted in their current form, what changes may be made before adoption, or when ultimate adoption will occur. Requirements to maintain higher levels of capital or to maintain higher levels of liquid assets could adversely impact the Corporation's net income and return on equity.

Liquidity Requirements

Historically, regulation and monitoring of bank and bank holding company liquidity has been addressed as a supervisory matter, without required formulaic measures. The Basel III final framework requires banks and bank holding companies to measure their liquidity against specific liquidity tests that, although similar in some respects to liquidity measures historically applied by banks and regulators for management and supervisory purposes, going forward will be required by regulation. One test, referred to as the liquidity coverage ratio (LCR), is designed to ensure that the banking entity maintains an adequate level of unencumbered high-quality liquid assets equal to the entity's expected net cash outflow for a 30-day time horizon (or, if greater, 25% of its expected total cash outflow) under an acute liquidity stress scenario. The other, referred to as the net stable funding ratio (NSFR), is designed to promote more medium- and long-term funding of the assets and activities of banking entities over a one-year time horizon. These requirements will incent banking entities to increase their holdings of U.S. Treasury securities and other sovereign debt as a component of assets and increase the use of long-term debt as a funding source. The Basel III framework contemplates that the LCR will remain subject to an observation period through mid-2013 and be implemented as a standard on January 1, 2015 and that the NSFR will be subject to an observation period through mid-2016 and be implemented as a minimum standard by January 1, 2018. These new standards are subject to further rulemaking and their terms may change before implementation. The federal banking agencies have not proposed rules implementing the Basel III liquidity framework and have not determined to what extent they will apply to U.S. banks that are not large, internationally active banks.

Anti-Money Laundering and the USA Patriot Act

A major focus of governmental policy on financial institutions in recent years has been aimed at combating money laundering and terrorist financing. The USA PATRIOT Act of 2001 (the USA Patriot Act) substantially broadened the scope of United States anti-money laundering laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial

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**ITEM 1. Business (Continued)
Supervision and Regulation (Continued)**

Anti-Money Laundering and the USA Patriot Act (Continued)

jurisdiction of the United States. The United States Treasury Department has issued and, in some cases, proposed a number of regulations that apply various requirements of the USA Patriot Act to financial institutions such as FCB. These regulations impose obligations on financial institutions to maintain appropriate policies, procedures and controls to detect, prevent and report money laundering and terrorist financing and to verify the identity of their customers. Certain of those regulations impose specific due diligence requirements on financial institutions that maintain correspondent or private banking relationships with non-U.S. financial institutions or persons. Failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution.

Availability of Financial Information

We file annual, quarterly and current reports, proxy statements and other information with the SEC. You may read and copy any document we file at the Securities and Exchange Commission's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Our SEC filings are also available to the public on the SEC website at www.sec.gov and on our website at www.fcbanking.com.

We also make available on our website, www.fcbanking.com, and in print to any shareholder who requests them, our Corporate Governance Guidelines, the charters for our Audit, Risk, Compensation and Human Resources, and Governance Committees, and the Code of Conduct and Ethics that applies to all of our directors, officers and employees.

Our Chief Executive Officer has certified to the New York Stock Exchange (NYSE) that, as of the date of the certification, he was not aware of any violation by First Commonwealth of NYSE's corporate governance listing standards. In addition, our Chief Executive Officer and Chief Financial Officer have made certain certifications concerning the information contained in this report pursuant to Section 302 of the Sarbanes-Oxley Act. The Section 302 certifications appear as Exhibits 31.1 and 31.2 to this annual report on Form 10-K.

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ITEM 1A. Risk Factors

As a financial services company, we are subject to a number of risks, many of which are outside of our control. These risks include, but are not limited to:

Changes in interest rates could negatively impact our financial condition and results of operations.

Our results of operations depend substantially on net interest income, which is the difference between interest earned on interest-earning assets (such as investments and loans) and interest paid on interest-bearing liabilities (such as deposits and borrowings). Interest rates are highly sensitive to many factors, including governmental monetary policies and domestic and international economic and political conditions. Conditions such as inflation, recession, unemployment, money supply, and other factors beyond our control may also affect interest rates. If our interest-earning assets mature or reprice more quickly than interest-bearing liabilities in a declining interest rate environment, net interest income could be adversely impacted. Likewise, if interest-bearing liabilities mature or reprice more quickly than interest-earnings assets in a rising interest rate environment, net interest income could be adversely impacted.

Changes in interest rates also can affect the value of loans and other assets. An increase in interest rates that adversely affects the ability of borrowers to pay the principal or interest on loans may lead to an increase in nonperforming assets and a reduction of income recognized, which could have a material adverse effect on our results of operations and cash flows.

We are subject to extensive government regulation and supervision.

Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds and the banking system as a whole, not security holders. These regulations affect our lending practices, capital structure, investment practices, dividend policy and growth, among other things. Congress and federal regulatory agencies continually review banking laws, regulations and policies for possible changes. The Dodd-Frank Act, enacted in July 2010, instituted major changes to the banking and financial institutions regulatory regimes in light of the recent performance of and government intervention in the financial services sector. Other changes to statutes, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could affect us in substantial and unpredictable ways. Such changes could subject us to additional costs, limit the types of financial services and products we may offer and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on our business, financial condition and results of operations. See "Supervision and Regulation" included in Item 1. Business for a more detailed description of the Dodd-Frank Act and other regulatory requirements applicable to First Commonwealth.

Further declines in real estate values could adversely affect our earnings and financial condition.

As of December 31, 2012, approximately 62% of our loans were secured by real estate. These loans consist of residential real estate loans (approximately 30% of total loans), commercial real estate loans (approximately 30% of total loans) and real estate construction loans (approximately 2% of total loans). Since the beginning of the economic recession in 2008, declines in real estate values and weak demand for new construction, particularly outside of our core Pennsylvania market, have caused deterioration in our loan portfolio and adversely impacted our financial condition and results of operations. Additional declines in real estate values, both within and outside of Pennsylvania, could adversely affect the value of the collateral for these loans, the ability of borrowers to make timely repayment of these loans and our ability to recoup the value of the collateral upon foreclosure, further impacting our earnings and financial condition.

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ITEM 1A. Risk Factors (Continued)

Our earnings are significantly affected by general business and economic conditions.

Our operations and profitability are impacted by general business and economic conditions in the United States and abroad. These conditions include short-term and long-term interest rates, inflation, money supply, political issues, legislative and regulatory changes, fluctuations in both debt and equity capital markets, broad trends in industry and finance and the strength of the United States economy, all of which are beyond our control. A deterioration in economic conditions could result in an increase in loan delinquencies and nonperforming assets, decreases in loan collateral values and a decrease in demand for our products and services, among other things, any of which could have a material adverse impact on our financial condition and results of operations.

Our allowance for credit losses may be insufficient.

All borrowers carry the potential to default and our remedies to recover may not fully satisfy money previously loaned. We maintain an allowance for credit losses, which is a reserve established through a provision for credit losses charged to expense, which represents management's best estimate of probable credit losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is adequate to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the allowance for credit losses reflects management's continuing evaluation of industry concentrations; specific credit risks; loan loss experience; current loan portfolio quality; present economic conditions; and unidentified losses in the current loan portfolio. The determination of the appropriate level of the allowance for credit losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks using existing qualitative and quantitative information, all of which may undergo material changes. Changes in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for credit losses. In addition, bank regulatory agencies periodically review our allowance for credit losses and may require an increase in the provision for credit losses or the recognition of additional loan charge-offs, based on judgments different than those of management. An increase in the allowance for credit losses results in a decrease in net income, and possibly risk-based capital, and may have a material adverse effect on our financial condition and results of operations.

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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ITEM 1A. Risk Factors (Continued)

We could suffer large losses due to the large size of certain loans.

As of December 31, 2012, we had 38 commercial loans with commitments greater than \$15.0 million with an aggregate amount of such commitments equal to \$907.8 million. If one or more of these large loans deteriorates or if the borrowers default, we could suffer losses which would have a significant impact on our earnings and financial condition.

We have a significant deferred tax asset and cannot assure it will be fully realized.

We had net deferred tax assets of \$64.1 million as of December 31, 2012. We did not establish a valuation allowance against our federal net deferred tax assets as of December 31, 2012 as we believe that it is more likely than not that all of these assets will be realized. In evaluating the need for a valuation allowance, we estimated future taxable income based on management approved forecasts. This process required significant judgment by management about matters that are by nature uncertain. If future events differ from our current forecasts, we may need to establish a valuation allowance, which could have a material adverse effect on our results of operations and financial condition.

We must evaluate whether any portion of our recorded goodwill is impaired. Impairment testing may result in a material, non-cash write-down of our goodwill assets and could have a material adverse impact on our results of operations.

At December 31, 2012, goodwill represented approximately 3% of our total assets. We have recorded goodwill because we paid more for some of our businesses than the fair market value of the tangible and separately measurable intangible net assets of those businesses. We test our goodwill and other intangible assets with indefinite lives for impairment at least annually (or whenever events occur which may indicate possible impairment). Goodwill impairment is determined by comparing the fair value of a reporting unit to its carrying amount, including goodwill. If the fair value exceeds the carrying amount, goodwill of the reporting unit is not considered impaired. If the fair value of the reporting unit is less than the carrying amount, goodwill is considered impaired. Determining the fair value of our company requires a high degree of subjective management assumptions. Any changes in key assumptions about our business and its prospects, changes in market conditions or other externalities, for impairment testing purposes could result in a non-cash impairment charge and such a charge could have a material adverse effect on our consolidated results of operations. The challenges of the current economic environment may adversely affect our earnings, the fair value of our assets and liabilities and our stock price, all of which may increase the risk of goodwill impairment.

We have significant exposure to a downturn in the financial services industry due to our investments in trust preferred securities.

As of December 31, 2012, we had single issuer trust preferred securities and trust preferred collateralized debt obligations with an aggregate book value of \$51.9 million and an unrealized loss of approximately \$23.4 million. These securities were issued by banks, bank holding companies and other financial services providers. Depending on the severe economic recession and its impact on the financial services industry, we may be required to record additional impairment charges on other investment securities if they suffer a decline in value that is considered other-than-temporary. If the credit quality of the securities in our investment portfolio deteriorates, we may also experience a loss in interest income from the suspension of either interest or dividend payments. Numerous factors, including lack of liquidity for resales of certain investment securities, absence of reliable pricing information for investment securities, adverse changes in business climate or adverse actions by regulators could have a negative effect on our investment portfolio in future periods. If an impairment charge is significant enough it could affect the ability of FCB to upstream dividends to us, which could have a material adverse effect on our liquidity and our ability to pay dividends to shareholders and could also negatively impact our regulatory capital ratios and result in us not being classified as well-capitalized for regulatory purposes.

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ITEM 1A. Risk Factors (Continued)

First Commonwealth relies on dividends from its subsidiaries for most of its revenues.

First Commonwealth is a separate and distinct legal entity from its subsidiaries. It receives substantially all of its revenues from dividends from its subsidiaries. These dividends are the principal source of funds to pay dividends on First Commonwealth's common stock and interest and principal on First Commonwealth's debt. Various federal and/or state laws and regulations limit the amount of dividends that FCB and certain non-bank subsidiaries may pay to First Commonwealth. In the event FCB is unable to pay dividends to First Commonwealth, First Commonwealth may not be able to service debt, pay obligations or pay dividends on its common stock. The inability to receive dividends from FCB could have a material adverse effect on First Commonwealth's business, financial condition and results of operations.

Competition from other financial institutions in originating loans, attracting deposits and providing various financial services may adversely affect our profitability.

We face substantial competition in originating loans and attracting deposits. This competition comes principally from other banks, savings institutions, mortgage banking companies and credit unions, as well as institutions offering uninsured investment alternatives, including money market funds. Many of our competitors enjoy advantages, including greater financial resources and higher lending limits, better brand recognition, a wider geographic presence, more accessible branch office locations, the ability to offer a wider array of services or more favorable pricing alternatives, as well as lower origination and operating costs. These competitors may offer more favorable pricing through lower interest rates on loans or higher interest rates on deposits, which could force us to match competitive rates and thereby reduce our net interest income.

Negative publicity could damage our reputation.

Reputation risk, or the risk to our earnings and capital from negative public opinion, is inherent in our business. Negative public opinion could adversely affect our ability to keep and attract customers and expose us to adverse legal and regulatory consequences. Negative public opinion could result from our actual or alleged conduct in any number of activities, including lending practices, corporate governance, regulatory compliance, mergers and acquisitions, and disclosure, sharing or inadequate protection of customer information, and from actions taken by government regulators and community organizations in response to that conduct. Because we conduct all of our business under the First Commonwealth brand, negative public opinion about one business could affect our other businesses.

An interruption to our information systems could adversely impact our operations.

We rely upon our information systems for operating and monitoring all major aspects of our business, including deposit and loan operations, as well as internal management functions. These systems and our operations could be damaged or interrupted by natural disasters, power loss, network failure, improper operation by our employees, security breaches, computer viruses, intentional attacks by third parties or other unexpected events. Any disruption in the operation of our information systems could adversely impact our operations, which may affect our financial condition, results of operations and cash flows.

Provisions of our articles of incorporation, bylaws and Pennsylvania law, as well as state and federal banking regulations, could delay or prevent a takeover of us by a third party.

Provisions in our articles of incorporation and bylaws, the corporate law of the Commonwealth of Pennsylvania, and state and federal regulations could delay, defer or prevent a third party from acquiring us, despite the possible benefit to our shareholders, or otherwise adversely affect the price of our common stock. These provisions include, among other things, advance notice requirements for proposing matters that shareholders may act on at shareholder meetings. In addition, under Pennsylvania law, we are prohibited from engaging in a

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ITEM 1A. Risk Factors (Continued)

business combination with any interested shareholder for a period of five years from the date the person became an interested shareholder unless certain conditions are met. These provisions may discourage potential takeover attempts, discourage bids for our common stock at a premium over market price or adversely affect the market price of, and the voting and other rights of the holders of, our common stock.

ITEM 1B. Unresolved Staff Comments

None.

ITEM 2. Properties

Our principal office is located in the old Indiana County courthouse complex, consisting of the former courthouse building and the former sheriff's residence and jail building for Indiana County. This certified Pennsylvania and national historic landmark was built in 1870 and restored by us in the early 1970s. We lease the complex from Indiana County pursuant to a lease agreement that was originally signed in 1973 and has a current term that expires in 2048.

The majority of our administrative personnel are also located in two owned buildings and one leased premise in Indiana, Pennsylvania, each of which is in close proximity to our principal office.

First Commonwealth Bank has 112 banking offices of which 27 are leased and 85 are owned. We also lease one loan production offices.

While these facilities are adequate to meet our current needs, available space is limited and additional facilities may be required to support future expansion. However, we have no current plans to lease, purchase or construct additional administrative facilities.

ITEM 3. Legal Proceedings

The information required by this Item is set forth in Part II, Item 8, Note 26, Contingent Liabilities, which is incorporated herein by reference in response to this item.

ITEM 4. Mine Safety Disclosures

Not applicable

Executive Officers of First Commonwealth Financial Corporation

The name, age and principal occupation for each of the executive officers of First Commonwealth Financial Corporation as of December 31, 2012 is set forth below:

I. Robert Emmerich, age 62, has served as Executive Vice President and Chief Credit Officer of First Commonwealth Bank since 2009. Prior to joining First Commonwealth, Mr. Emmerich was retired from a 31-year career at National City Corporation, where he most recently served as Executive Vice President & Chief Credit Officer for Consumer Lending.

Leonard V. Lombardi, age 53, has served as Executive Vice President and Chief Audit Executive of First Commonwealth Financial Corporation since January 1, 2009. He was formerly Senior Vice President / Loan Review and Audit Manager.

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Executive Officers of First Commonwealth Financial Corporation (Continued)

Norman J. Montgomery, age 45, has served as the Executive Vice President of Business Integration of First Commonwealth Bank since May 2011. He oversees First Commonwealth's product development, marketing and business analysis functions and assumed oversight of First Commonwealth's technology and operations functions in July 2012. He served as Senior Vice President/Business Integration of First Commonwealth Bank from September 2007 until May 2011 and previously held positions in the technology, operations and audit areas.

T. Michael Price, age 50, has served as President of First Commonwealth Bank since November 2007. On March 7, 2012, he began serving as President and Chief Executive Officer of First Commonwealth Financial Corporation. From January 1, 2012 to March 7, 2012, he served as Interim President and Chief Executive Officer of First Commonwealth Financial Corporation. He was formerly Chief Executive Officer of the Cincinnati and Northern Kentucky Region of National City Bank from July 2004 to November 2007 and Executive Vice President and Head of Small Business Banking of National City Bank prior to July 2004.

Robert E. Rout, age 61, joined First Commonwealth Financial Corporation as Executive Vice President and Chief Financial Officer in February 2010. Prior to joining First Commonwealth, Mr. Rout served as Chief Financial Officer and Secretary for S&T Bancorp, Inc. in Indiana, PA, since 1999 and as Chief Administrative Officer of S&T Bancorp, Inc. since April 2008.

Matthew C. Tomb, age 36, has served as Executive Vice President, Chief Risk Officer and General Counsel of First Commonwealth Financial Corporation since November 2010. He previously served as Senior Vice President / Legal and Compliance since September 2007. Before joining First Commonwealth, Mr. Tomb practiced law with Sherman & Howard L.L.C. in Denver, Colorado.

Table of Contents**PART II****ITEM 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchase of Equity Securities**

First Commonwealth is listed on the NYSE under the symbol FCF. As of December 31, 2012, there were approximately 9,002 holders of record of First Commonwealth's common stock. The table below sets forth the high and low sales prices per share and cash dividends declared per share for common stock of First Commonwealth for each quarter during the last two fiscal years.

Period	High Sale	Low Sale	Cash Dividends Per Share
2012			
First Quarter	\$ 6.68	\$ 5.47	\$ 0.03
Second Quarter	6.73	5.73	0.05
Third Quarter	7.55	6.67	0.05
Fourth Quarter	7.30	5.92	0.05

Period	High Sale	Low Sale	Cash Dividends Per Share
2011			
First Quarter	\$ 7.36	\$ 6.11	\$ 0.03
Second Quarter	6.96	5.18	0.03
Third Quarter	5.89	3.66	0.03
Fourth Quarter	5.45	3.55	0.03

Federal and state regulations contain restrictions on the ability of First Commonwealth to pay dividends. For information regarding restrictions on dividends, see Part I, Item 1 Business Supervision and Regulation Restrictions on Dividends and Part II, Item 8, Financial Statements and Supplementary Data Note 28, Regulatory Restrictions and Capital Adequacy. In addition, under the terms of the capital securities issued by First Commonwealth Capital Trust I, II, and III, First Commonwealth could not pay dividends on its common stock if First Commonwealth deferred payments on the junior subordinated debt securities which provide the cash flow for the payments on the capital securities.

Table of Contents**ITEM 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchase of Equity Securities**
(Continued)

The following five-year performance graph compares the cumulative total shareholder return (assuming reinvestment of dividends) on First Commonwealth's common stock to the KBW Regional Banking Index and the Russell 2000 Index. The stock performance graph assumes \$100 was invested on December 31, 2007, and the cumulative return is measured as of each subsequent fiscal year end.

Index	Period Ending					
	12/31/2007	12/31/2008	12/31/2009	12/31/2010	12/31/2011	12/31/2012
First Commonwealth Financial Corporation	100.00	123.31	47.39	72.88	55.32	73.75
Russell 2000	100.00	66.21	84.20	106.82	102.36	119.09
KBW Regional Banking Index	100.00	81.42	63.41	76.34	72.41	82.12

Table of Contents**ITEM 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchase of Equity Securities**
(Continued)**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. The following table details the amount of shares repurchased under this program during the fourth 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
October 31, 2012	1,335,500	\$ 6.78	1,335,500	4,860,568
November 30, 2012	1,694,409	6.29	1,694,409	3,302,800
December 31, 2012	1,290,274	6.69	1,290,274	1,838,716
Total	4,320,183	\$ 6.56	4,320,183	

* Remaining number of shares approved under the Plan is estimated based on the market value of the Company's common stock of \$6.55 at October 31, 2012, \$6.41 at November 30, 2012 and \$6.82 at December 31, 2012.

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The following selected financial data is not covered by the auditor's report and should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations, which follows, and with the Consolidated Financial Statements and related notes.

	Periods Ended December 31,				
	2012	2011	2010	2009	2008
	(dollars in thousands, except share data)				
Interest income	\$ 219,075	\$ 231,545	\$ 268,360	\$ 293,281	\$ 327,596
Interest expense	30,146	41,678	61,599	86,771	138,998
Net interest income	188,929	189,867	206,761	206,510	188,598
Provision for credit losses	20,544	55,816	61,552	100,569	23,095
Net interest income after provision for credit losses	168,385	134,051	145,209	105,941	165,503
Net impairment losses	0	0	(9,193)	(36,185)	(13,011)
Net securities gains	192	2,185	2,422	273	1,517
Other income	65,242	55,484	56,005	55,237	54,325
Other expenses	177,207	176,826	171,226	171,151	158,615
Income (Loss) before income taxes	56,612	14,894	23,217	(45,885)	49,719
Income tax provision (benefit)	14,658	(380)	239	(25,821)	6,632
Net Income (Loss)	\$ 41,954	\$ 15,274	\$ 22,978	\$ (20,064)	\$ 43,087
Per Share Data Basic					
Net Income (Loss)	\$ 0.40	\$ 0.15	\$ 0.25	\$ (0.24)	\$ 0.58
Dividends declared	\$ 0.18	\$ 0.12	\$ 0.06	\$ 0.18	\$ 0.68
Average shares outstanding	103,885,396	104,700,227	93,197,225	84,589,780	74,477,795
Per Share Data Diluted					
Net Income (Loss)	\$ 0.40	\$ 0.15	\$ 0.25	\$ (0.24)	\$ 0.58
Average shares outstanding	103,885,663	104,700,393	93,199,773	84,589,780	74,583,236
At End of Period					
Total assets	\$ 5,995,390	\$ 5,841,122	\$ 5,812,842	\$ 6,446,293	\$ 6,425,880
Investment securities	1,199,531	1,182,572	1,016,574	1,222,045	1,452,191
Loans and leases, net of unearned income	4,204,704	4,057,055	4,218,083	4,636,501	4,418,377
Allowance for credit losses	67,187	61,234	71,229	81,639	52,759
Deposits	4,557,881	4,504,684	4,617,852	4,535,785	4,280,343
Short-term borrowings	356,227	312,777	187,861	958,932	1,139,737
Subordinated debentures	105,750	105,750	105,750	105,750	105,750
Other long-term debt	174,471	101,664	98,748	168,697	183,493
Shareholders' equity	746,007	758,543	749,777	638,811	652,779
Key Ratios					
Return on average assets	0.71%	0.27%	0.37%	(0.31)%	0.70%
Return on average equity	5.46	2.00	3.33	(3.06)	7.45
Net loans to deposits ratio	90.78	88.70	89.80	100.42	101.99
Dividends per share as a percent of net income per share	44.57	82.26	23.72	NA	117.54
Average equity to average assets ratio	12.95	13.33	11.26	10.16	9.35

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ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis represents an overview of the financial condition and the results of operations of First Commonwealth and its subsidiaries, FCB, First Commonwealth Insurance Agency, Inc. (FCIA) and First Commonwealth Financial Advisors, Inc. (FCFA), as of and for the years ended December 31, 2012, 2011 and 2010. The purpose of this discussion is to focus on information concerning our financial condition and results of operations that is not readily apparent from the Consolidated Financial Statements. In order to obtain a clear understanding of this discussion, you should refer to the Consolidated Financial Statements, the notes thereto and other financial information presented in this Annual Report.

Company Overview

First Commonwealth provides a diversified array of consumer and commercial banking services through our bank subsidiary, FCB. We also provide trust and wealth management services through FCFA and insurance products through FCIA. At December 31, 2012, FCB operated 112 community banking offices throughout western Pennsylvania and one loan production office in downtown Pittsburgh, Pennsylvania.

Our consumer services include Internet, mobile and telephone banking, an automated teller machine network, personal checking accounts, interest-earning checking accounts, savings accounts, insured money market accounts, debit cards, investment certificates, fixed and variable rate certificates of deposit, secured and unsecured installment loans, construction and real estate loans, safe deposit facilities, credit lines with overdraft checking protection and IRA accounts. Commercial banking services include commercial lending, small and high-volume business checking accounts, on-line account management services, ACH origination, payroll direct deposit, commercial cash management services and repurchase agreements. We also provide a variety of trust and asset management services and a full complement of auto, home and business insurance as well as term life insurance. We offer annuities, mutual funds, stock and bond brokerage services through an arrangement with a broker-dealer and insurance brokers. Most of our commercial customers are small and mid-sized businesses in central and western Pennsylvania.

As a financial institution with a focus on traditional banking activities, we earn the majority of our revenue through net interest income, which is the difference between interest earned on loans and investments and interest paid on deposits and borrowings. Growth in net interest income is dependent upon balance sheet growth and maintaining or increasing our net interest margin, which is net interest income (on a fully taxable-equivalent basis) as a percentage of our average interest-earning assets. We also generate revenue through fees earned on various services and products that we offer to our customers and through sales of assets, such as loans, investments or properties. These revenue sources are offset by provisions for credit losses on loans, loss on sale or other-than-temporary impairments on investment securities, operating expenses and income taxes.

General economic conditions also affect our business by impacting our customers' need for financing, thus affecting loan growth, and impacting the credit strength of existing and potential borrowers.

Critical Accounting Policies and Significant Accounting Estimates

First Commonwealth's accounting and reporting policies conform to accounting principles generally accepted in the United States of America (GAAP) and predominant practice in the banking industry. The preparation of financial statements in accordance with GAAP requires management to make estimates, assumptions and judgments that affect the amounts reported in the financial statements and accompanying notes. Over time, these estimates, assumptions and judgments may prove to be inaccurate or vary from actual results and may significantly affect our reported results and financial position for the period presented or in future periods. We currently view the determination of the allowance for credit losses, fair value of financial instruments, goodwill and other intangible assets, and income taxes to be critical because they are highly dependent on subjective or complex judgments, assumptions and estimates made by management.

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ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued) Critical Accounting Policies and Significant Accounting Estimates (Continued)

Allowance for Credit Losses

We account for the credit risk associated with our lending activities through the allowance and provision for credit losses. The allowance represents management's best estimate of probable losses that are inherent in our existing loan portfolio as of the balance sheet date. The provision is a periodic charge to earnings in an amount necessary to maintain the allowance at a level that is appropriate based on management's assessment of probable estimated losses. Management determines and reviews with the Board of Directors the adequacy of the allowance on a quarterly basis in accordance with the methodology described below.

Individual loans are selected for review in accordance with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 310, Receivables. These are generally large balance commercial loans and commercial mortgages that are rated less than satisfactory based on our internal credit-rating process.

We assess whether the loans identified for review in step one are impaired, which means that it is probable that all amounts will not be collected according to the contractual terms of the loan agreement, which generally represents loans that management has placed on nonaccrual status.

For impaired loans we calculate the estimated fair value of the loans that are selected for review based on observable market prices, discounted cash flows or the value of the underlying collateral and record an allowance if needed.

We then select pools of homogenous smaller balance loans having similar risk characteristics as well as unimpaired larger commercial loans for evaluation collectively under the provisions of FASB ASC Topic 450, Contingencies. These smaller balance loans generally include residential mortgages, consumer loans, installment loans and some commercial loans.

FASB ASC Topic 450 loans are segmented into groups with similar characteristics and an allowance for credit losses is allocated to each segment based on recent loss history and other relevant information.

We then review the results to determine the appropriate balance of the allowance for credit losses. This review includes consideration of additional factors, such as the mix of loans in the portfolio, the balance of the allowance relative to total loans and nonperforming assets, trends in the overall risk profile in the portfolio, trends in delinquencies and nonaccrual loans, and local and national economic information and industry data, including trends in the industries we believe are higher risk.

There are many factors affecting the allowance for credit losses; some are quantitative while others require qualitative judgment. These factors require the use of estimates related to the amount and timing of expected future cash flows, appraised values on impaired loans, collateral valuations for classified loans that are not impaired, estimated losses for each loan category based on historical loss experience and delinquency trends by category using a four to twenty quarter average, and consideration of current economic trends and conditions, all of which may be susceptible to significant judgment and change. To the extent that actual outcomes differ from estimates, additional provisions for credit losses could be required that could adversely affect our earnings or financial position in future periods. The loan portfolio represents the largest asset category on our Consolidated Statements of Financial Condition.

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ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued) Critical Accounting Policies and Significant Accounting Estimates (Continued)

Fair Values of Financial Instruments

FASB ASC Topic 820, Fair Value Measurements and Disclosures, establishes a framework for measuring fair value. 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 markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1 valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities. Level 2 valuations are for instruments that trade in less active dealer or broker markets and incorporates values obtained for identical or comparable instruments. Level 3 valuations 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. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to each instrument.

Level 2 investment securities are valued by a recognized third party pricing service using observable inputs. Management validates the market values provided by the third party service by having another recognized pricing service price 100% of securities on an annual basis and 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.

Level 3 investments include pooled trust preferred collateralized debt obligations. The fair values of these investments are determined by a specialized third party valuation service. 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 by confirming changes in the underlying collateral to the trustee and underwriter 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.

Methodologies and estimates used by management when determining the fair value for pooled trust preferred collateralized debt obligations and testing those securities for other-than-temporary impairment are discussed in detail in Management's Discussion and Analysis of Financial Condition and Results of Operations and in Note 11 Impairment of Investment Securities and Note 21 Fair Values of Assets and Liabilities of Notes to the Consolidated Financial Statements.

Goodwill and Other Intangible Assets

We consider our accounting policies related to goodwill and other intangible assets to be critical because the assumptions or judgment used in determining the fair value of assets and liabilities acquired in past acquisitions are subjective and complex. As a result, changes in these assumptions or judgment could have a significant impact on our financial condition or results of operations.

The fair value of acquired assets and liabilities, including the resulting goodwill, was based either on quoted market prices or provided by other third-party sources, when available. When third-party information was not available, estimates were made in good faith by management primarily through the use of internal cash flow modeling techniques. The assumptions that were used in the cash flow modeling were subjective and are susceptible to significant changes.

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ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)
Critical Accounting Policies and Significant Accounting Estimates (Continued)

Goodwill and Other Intangible Assets (Continued)

Goodwill and other intangible assets with indefinite useful lives are tested for impairment at least annually and written down and charged to results of operations only in periods in which the recorded value is more than the estimated fair value. Intangible assets that have finite useful lives will continue to be amortized over their useful lives and are periodically evaluated for impairment.

As of December 31, 2012, goodwill and other intangible assets were not considered impaired; however, changing economic conditions that may adversely affect our performance and stock price could result in impairment, which could adversely affect earnings in future periods. Our Step 1 goodwill impairment analysis as of November 30, 2012, determined that the fair value of our goodwill exceeded its carrying value by approximately 6%. An assessment of qualitative factors was completed as of December 31, 2012 and indicated that it is more likely than not that our fair value exceeded its carrying value.

Income Taxes

We estimate income tax expense based on amounts expected to be owed to the tax jurisdictions where we conduct business. On a quarterly basis, management assesses the reasonableness of its effective tax rate based upon its current estimate of the amount and components of net income, tax credits and the applicable statutory tax rates expected for the full year.

Deferred income tax assets and liabilities are determined using the asset and liability method and are reported in the Consolidated Statements of Financial Condition. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. If current available information raises doubt as to the realization of the deferred tax assets, a valuation allowance is established. Deferred tax assets and liabilities are measured using enacted tax rates expected to be applied to taxable income in the years in which those temporary differences are expected to be recovered or settled. Management assesses all available positive and negative evidence on a quarterly basis to estimate if sufficient future taxable income will be generated to utilize the existing deferred tax assets. The amount of future taxable income used in management's valuation is based upon management approved forecasts, evaluation of historical earnings levels, proven ability to raise capital to support growth or during times of economic stress and consideration of prudent and feasible potential tax strategies. If future events differ from our current forecasts, a valuation allowance may be required, which could have a material impact on our financial condition and results of operations.

Accrued taxes represent the net estimated amount due to taxing jurisdictions and are reported in other liabilities in the Consolidated Statements of Financial Condition. Management evaluates and assesses the relative risks and appropriate tax treatment of transactions and filing positions after considering statutes, regulations, judicial precedent and other information and maintains tax accruals consistent with its evaluation of these relative risks and merits. Changes to the estimate of accrued taxes occur periodically due to changes in tax rates, interpretations of tax laws, the status of examinations being conducted by taxing authorities and changes to statutory, judicial and regulatory guidance. These changes, when they occur, can affect deferred taxes and accrued taxes, as well as the current period's income tax expense and can be significant to our operating results.

Results of Operations 2012 Compared to 2011

Net Income

Net income for 2012 was \$42.0 million, or \$0.40 per diluted share, as compared to net income of \$15.3 million, or \$0.15 per diluted share, in 2011. The increase in 2012 performance was primarily the result of a \$35.3 million

Table of Contents**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**
Results of Operations 2012 Compared to 2011 (Continued)**Net Income** (Continued)

decrease in provision expense, a decrease of \$2.0 million related to loss on sale or write-down of assets, and a \$7.4 million decrease in credit risk recognized on interest rate swaps. Partially offsetting the aforementioned items are a \$0.9 million decrease in net interest income, a \$2.0 million decrease in net securities gains, and a \$3.6 million increase in operational losses.

Our return on average equity was 5.5% and return on average assets was 0.71% for 2012, compared to 2.0% and 0.27%, respectively, for 2011.

Average diluted shares for the year 2012 were 1% less than the comparable period in 2011 primarily due to the common stock buyback program that was authorized during 2012.

Net Interest Income

Net interest income, which is our primary source of revenue, is the difference between interest income from earning assets (loans and securities) and interest expense paid on liabilities (deposits, short-term borrowings and long-term debt). The amount of net interest income is affected by both changes in the level of interest rates and the amount and composition of interest-earning assets and interest-bearing liabilities. The net interest margin is expressed as the percentage of net interest income, on a fully taxable equivalent basis, to average interest-earning assets. To compare the tax exempt asset yields to taxable yields, amounts are adjusted to the pretaxable equivalent amounts based on the marginal corporate federal income tax rate of 35%. The taxable equivalent adjustment to net interest income for 2012 was \$4.4 million compared to \$5.5 million in 2011.

Net interest income, on a fully taxable equivalent basis, was \$193.3 million for the year-ended December 31, 2012, a \$2.1 million, or 1%, decrease compared to \$195.4 million for the same period in 2011. The net interest margin, on a fully taxable equivalent basis decreased 19 basis points, or 5%, to 3.61% in 2012 from 3.80% in 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.

During the year-ended December 31, 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 year increased \$212.1 million, or 4%, compared to the comparable period in 2011. Positively impacting the net interest margin for the year 2012 was the recognition of \$1.0 million in interest income related to the payoff of a loan that was previously in nonaccrual status and \$0.5 million in interest income recognized as an adjustment of yield for a loan that was returned to accrual status. These contributed 3 basis points to the net interest margin for the year 2012. Given the current interest rate environment, it is expected that the challenges to the net interest margin will continue as \$2.8 billion in interest-sensitive assets either reprice or mature over the next twelve months.

The taxable equivalent yield on interest-earning assets was 4.18% for the year-ended December 31, 2012, a decrease of 43 basis points from the 4.61% yield for the same period in 2011. This decline can be attributed to the repricing of our variable rate assets in a low 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 0.70% for the year-ended December 31, 2012, compared to 0.99% for the same period in 2011.

Table of Contents**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)
Results of Operations 2012 Compared to 2011 (Continued)****Net Interest Income** (Continued)

Comparing the year-ended December 31, 2012 with the same period in 2011, changes in interest rates negatively impacted net interest income by \$13.3 million. The lower yield on interest-earning assets adversely impacted net interest income by \$22.7 million, while the decline in the cost of interest-bearing liabilities had a positive impact of \$9.4 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 deposits 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 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 \$11.3 million in the year-ended December 31, 2012 compared to the same period in 2011. Higher levels of interest-earning assets resulted in an increase of \$9.2 million in interest income, while volume changes primarily attributed to the mix of deposits reduced interest expense by \$2.1 million.

Positively affecting net interest income was a \$97.2 million increase in average net free funds at December 31, 2012 as compared to December 31, 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 a \$90.0 million increase in average noninterest-bearing demand deposits 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 year-ended December 31, 2012 decreased \$205.2 million, or 15%, compared to the comparable period in 2011. The positive change in deposit mix is expected to continue as \$511.1 million in certificates of deposits either mature or reprice over the next twelve months.

The following table reconciles interest income in the Consolidated Statements of Income to net interest income adjusted to a fully taxable equivalent basis for the periods presented:

	For the Years Ended December 31,		
	2012	2011	2010
	(dollars in thousands)		
Interest income per Consolidated Statements of Income	\$ 219,075	\$ 231,545	\$ 268,360
Adjustment to fully taxable equivalent basis	4,392	5,500	9,174
Interest income adjusted to fully taxable equivalent basis (non-GAAP)	223,467	237,045	277,534
Interest expense	30,146	41,678	61,599
Net interest income adjusted to fully taxable equivalent basis (non-GAAP)	\$ 193,321	\$ 195,367	\$ 215,935

Table of Contents**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**
Results of Operations 2012 Compared to 2011 (Continued)**Net Interest Income** (Continued)

The following table provides information regarding the average balances and yields and rates on interest-earning assets and interest-bearing liabilities for the periods ended December 31:

	Average Balance Sheets and Net Interest Analysis								
	2012			2011			2010		
	Average Balance	Income / Expense (a)	Yield or Rate	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	\$ 4,329	\$ 6	0.14%	\$ 26,477	\$ 64	0.24%	\$ 37,043	\$ 94	0.25%
Tax-free investment securities	271	18	6.64	4,852	328	6.76	120,239	8,025	6.67
Taxable investment securities	1,179,169	31,799	2.70	1,043,798	33,812	3.24	939,459	37,988	4.04
Loans, net of unearned income (b)(c)	4,165,292	191,644	4.60	4,061,822	202,841	4.99	4,467,338	231,427	5.18
Total interest-earning assets	5,349,061	223,467	4.18	5,136,949	237,045	4.61	5,564,079	277,534	4.99
Noninterest-earning assets:									
Cash	75,044			75,071			77,259		
Allowance for credit losses	(65,279)			(76,814)			(96,872)		
Other assets	581,321			593,248			592,612		
Total noninterest-earning assets	591,086			591,505			572,999		
Total Assets	\$ 5,940,147			\$ 5,728,454			\$ 6,137,078		
Liabilities and Shareholders Equity									
Interest-bearing liabilities:									
Interest-bearing demand deposits (d)									
	\$ 645,970	\$ 286	0.04%	\$ 607,756	\$ 515	0.08%	\$ 622,171	\$ 751	0.12%
Savings deposits (d)	1,921,417	4,233	0.22	1,877,321	7,252	0.39	1,800,418	12,171	0.68
Time deposits	1,138,112	16,935	1.49	1,343,281	25,729	1.92	1,596,088	36,923	2.31
Short-term borrowings	402,196	1,070	0.27	182,864	728	0.40	488,078	1,948	0.40
Long-term debt	202,598	7,622	3.76	184,185	7,454	4.05	236,939	9,806	4.14
Total interest-bearing liabilities	4,310,293	30,146	0.70	4,195,407	41,678	0.99	4,743,694	61,599	1.30
Noninterest-bearing liabilities and shareholders equity:									
Noninterest-bearing demand deposits (d)									
	810,041			720,005			658,947		
Other liabilities	50,859			49,163			43,413		
Shareholders equity	768,954			763,879			691,024		
Total noninterest-bearing funding sources	1,629,854			1,533,047			1,393,384		
	\$ 5,940,147			\$ 5,728,454			\$ 6,137,078		

**Total Liabilities and Shareholders
Equity**

**Net Interest Income and Net Yield
on Interest-Earning Assets**

\$ 193,321	3.61%	\$ 195,367	3.80%	\$ 215,935	3.88%
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- (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.
- (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.

Table of Contents**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)
Results of Operations 2012 Compared to 2011 (Continued)**Net Interest Income (Continued)

The following table sets forth certain information regarding changes in net interest income attributable to changes in the volumes of interest-earning assets and interest-bearing liabilities and changes in the rates for the periods indicated:

	Analysis of Year-to-Year Changes in Net Interest Income			Analysis of Year-to-Year Changes in Net Interest Income		
	2012 Change from 2011			2011 Change from 2010		
	Total Change	Change Due To Volume	Change Due To Rate (a)	Total Change	Change Due To Volume	Change Due To Rate (a)
	(dollars in thousands)					
Interest-earning assets:						
Interest-bearing deposits with banks	\$ (58)	\$ (53)	\$ (5)	\$ (30)	\$ (26)	\$ (4)
Tax-free investment securities	(310)	(310)	0	(7,697)	(7,696)	(1)
Taxable investment securities	(2,013)	4,386	(6,399)	(4,176)	4,215	(8,391)
Loans	(11,197)	5,163	(16,360)	(28,586)	(21,006)	(7,580)
Total interest income (b)	(13,578)	9,186	(22,764)	(40,489)	(24,513)	(15,976)
Interest-bearing liabilities:						
Interest-bearing demand deposits	(229)	31	(260)	(236)	(17)	(219)
Savings deposits	(3,019)	172	(3,191)	(4,919)	523	(5,442)
Time deposits	(8,794)	(3,939)	(4,855)	(11,194)	(5,840)	(5,354)
Short-term borrowings	342	877	(535)	(1,220)	(1,221)	1
Long-term debt	168	746	(578)	(2,352)	(2,184)	(168)
Total interest expense	(11,532)	(2,113)	(9,419)	(19,921)	(8,739)	(11,182)
Net interest income	\$ (2,046)	\$ 11,299	\$ (13,345)	\$ (20,568)	\$ (15,774)	\$ (4,794)

(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.

The provision for credit losses for the year 2012 totaled \$20.5 million, a decrease of \$35.3 million, or 63%, compared to the year 2011. This provision exceeded net credit losses for the year 2012 by \$14.6 million.

Table of Contents**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)
Results of Operations 2012 Compared to 2011 (Continued)**Provision for Credit Losses (Continued)

The table below provides a breakout of the provision for credit losses by loan category for the years ended December 31:

	2012		2011	
	Dollars	Percentage	Dollars	Percentage
	(dollars in thousands)			
Commercial, financial, agricultural and other	\$ 6,416	31%	\$ 3,141	6%
Real estate construction	5,191	26	16,685	30
Residential real estate	1,077	5	6,758	12
Commercial real estate	3,921	19	26,560	47
Loans to individuals	2,849	14	2,781	5
Unallocated	1,090	5	(109)	0
Total	\$ 20,544	100%	\$ 55,816	100%

As evidenced by the table, the current year provision is largely the result of the commercial financial, agricultural and other, real estate construction and commercial real estate portions of the portfolio.

The provision for credit losses for commercial, financial, agricultural and other loans is primarily due to increases of \$4.9 million in specific reserves related to three loan relationships that were placed in nonaccrual status during 2012. Of the \$5.2 million provision for credit losses related to construction loans, \$4.6 million can be attributed to the impact historical losses had on the allowance for loan loss calculation. The commercial real estate provision for credit losses can be attributed to specific reserves of \$5.3 million related to two loan relationships that were placed in nonaccrual status during 2012. The \$1.1 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 \$67.2 million, or 1.60%, of total loans outstanding at December 31, 2012, compared to \$61.2 million, or 1.51%, at December 31, 2011. Nonperforming loans as a percentage of total loans decreased to 2.56% at December 31, 2012 from 2.76% at December 31, 2011. The allowance to nonperforming loan ratio was 62% as of December 31, 2012 and 2011. The decline in net charge-offs for the year contributed to the lower level of provision for credit losses for the year-ended December 31, 2012.

Net credit losses were \$14.6 million for the year-ended December 31, 2012 compared to \$65.8 million for the same period in 2011. The most significant credit losses recognized during the year-ended December 31, 2012, were a \$2.2 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 period did not include any other significant individual charge-offs.

The provision is a result of management's assessment of credit quality statistics and other factors that would have an impact on probable losses in the loan portfolio and the methodology used for determination of the adequacy of the allowance for credit losses. The change in the allowance for credit losses is consistent with the increase in estimated losses within the loan portfolio determined by factors including certain loss events, portfolio migration analysis, historical loss experience, delinquency trends, deterioration in collateral values and volatility in the economy. Management believes that the allowance for credit losses is at a level deemed sufficient to absorb losses inherent in the loan portfolio at December 31, 2012.

Table of Contents**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**
Results of Operations 2012 Compared to 2011 (Continued)*Provision for Credit Losses* (Continued)

A detailed analysis of our credit loss experience for the previous five years is shown below:

	2012	2011	2010	2009	2008
	(dollars in thousands)				
Loans outstanding at end of year	\$ 4,204,704	\$ 4,057,055	\$ 4,218,083	\$ 4,636,501	\$ 4,418,377
Average loans outstanding	\$ 4,165,292	\$ 4,061,822	\$ 4,467,338	\$ 4,557,227	\$ 4,084,506
Balance, beginning of year	61,234	71,229	81,639	52,759	42,396
Loans charged off:					
Commercial, financial, agricultural and other	5,207	7,114	22,293	20,536	3,640
Real estate construction	3,601	28,886	41,483	36,892	67
Residential real estate	3,828	4,107	5,226	4,604	2,529
Commercial real estate	851	24,861	2,466	7,302	3,479
Loans to individuals	3,482	3,325	3,841	4,378	4,166
Total loans charged off	16,969	68,293	75,309	73,712	13,881
Recoveries of loans previously charged off:					
Commercial, financial, agricultural and other	443	473	2,409	448	426
Real estate construction	582	955	0	0	0
Residential real estate	422	132	252	81	14
Commercial real estate	410	349	163	914	187
Loans to individuals	521	573	523	580	522
Total recoveries	2,378	2,482	3,347	2,023	1,149
Net credit losses	14,591	65,811	71,962	71,689	12,732
Provision charged to expense	20,544	55,816	61,552	100,569	23,095
Balance, end of year	\$ 67,187	\$ 61,234	\$ 71,229	\$ 81,639	\$ 52,759
Ratios:					
Net credit losses as a percentage of average loans outstanding	0.35%	1.62%	1.61%	1.57%	0.31%
Allowance for credit losses as a percentage of end-of-period loans outstanding	1.60%	1.51%	1.69%	1.76%	1.19%

Table of Contents**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**
Results of Operations 2012 Compared to 2011 (Continued)Noninterest Income

The components of noninterest income for each year in the three-year period ended December 31 are as follows:

	2012	2011	2010	2012 compared to 2011	
				\$ Change	% Change
	(dollars in thousands)				
Noninterest Income:					
Trust income	\$ 6,206	\$ 6,498	\$ 5,897	\$ (292)	(4)%
Service charges on deposit accounts	14,743	14,775	16,968	(32)	(0)
Insurance and retail brokerage commissions	6,272	6,376	6,369	(104)	(2)
Income from bank owned life insurance	5,850	5,596	5,331	254	5
Card related interchange income	13,199	11,968	10,459	1,231	10
Other income	13,610	12,803	10,016	807	6
Subtotal	59,880	58,016	55,040	1,864	3
Net impairment losses	0	0	(9,193)	0	0
Net securities gains	192	2,185	2,422	(1,993)	(91)
Gain on sale of assets	4,607	4,155	824	452	11
Derivatives mark to market	755	(6,687)	141	7,442	(111)
Total noninterest income	\$ 65,434	\$ 57,669	\$ 49,234	\$ 7,765	13%

Noninterest income, excluding gains and losses on sales, impairment losses on assets and derivatives mark to market increased \$1.9 million, or 3%, in 2012. The most significant changes included increases in card related interchange income and other income. The increase in card related interchange income can be attributed to both growth in the number deposit customers as well as continued increases in electronic payments by our customers. The increase in other income is primarily attributable to a \$1.9 million termination fee related 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. Also contributing to the increase in other income are fees earned on interest rate swaps. The fees earned on these swaps are based on the notional value of the initiated contracts. In comparison, 14 swaps with a notional value of \$117.2 million were entered into during the year-ended December 31, 2012 and provided income of \$1.3 million, while 9 swaps with a notional value of \$44.9 million were entered into during the same period in 2011, providing income of \$0.6 million. Offsetting these increases in other income was a decrease of \$0.9 million in letter of credit fees.

Total noninterest income increased \$7.8 million or 13%. The most notable change in this total is a \$7.4 million increase in the mark-to-market adjustment recognized on derivatives. This increase is primarily the result of \$0.8 million of income recognized in relation to the mark-to-market adjustment on interest rate derivatives during 2012 while a \$6.7 million decline in income was recognized during the same period in 2011. The 2011 decline in income was the result of an adverse mark-to-market adjustment related to credit deterioration for one commercial relationship. The 2012 income is a result of changes in the credit default curves over time as well as improvement in the counterparty credit risk related to one interest rate swap.

The gain on sale of assets for the year 2012 totaled \$4.6 million, of which \$2.9 million related to the sale of three loans transferred to held for sale in the fourth quarter of 2011. The sale of these loans were completed in the first and second quarters of 2012. For the year 2011, the gain on sale of assets included a \$1.1 million gain on the sale of a private equity investment and \$2.4 million in gains related to the sale of other real estate owned.

Comparing the year 2012 to the year 2011, net securities gains decreased \$2.0 million as the result of a \$1.5 million gain recognized in 2011 from the sale of an equity security.

Table of Contents**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**
Results of Operations 2012 Compared to 2011 (Continued)*Noninterest Expense*

The components of noninterest expense for each year in the three-year period ended December 31 are as follows:

	2012	2011	2010	2012 compared to 2011	
				\$ Change	% Change
	(dollars in thousands)				
Noninterest Expense:					
Salaries and employee benefits	\$ 86,069	\$ 84,669	\$ 84,988	\$ 1,400	2%
Net occupancy expense	13,255	14,069	14,271	(814)	(6)
Furniture and equipment expense	12,460	12,517	12,568	(57)	(0)
Data processing expense	7,054	6,027	5,671	1,027	17
Pennsylvania shares tax expense	5,706	5,480	5,455	226	4
Intangible amortization	1,467	1,534	2,031	(67)	(4)
Collection and repossession expense	5,756	7,583	4,430	(1,827)	(24)
Other professional fees and services	4,329	5,297	4,131	(968)	(18)
FDIC insurance	5,032	5,490	7,948	(458)	(8)
Other operating expenses	24,318	23,953	26,437	365	2
Subtotal	165,446	166,619	167,930	(1,173)	(1)
Loss on sale or write-down of assets	7,394	9,428	2,715	(2,034)	(22)
Operational losses	4,367	779	581	3,588	461
Total noninterest expense	\$ 177,207	\$ 176,826	\$ 171,226	\$ 381	0%

Total noninterest expense remained relatively consistent for the year 2012 in comparison to the year 2011. However, several categories reflected large variances in the level of expense.

During the third quarter of 2012, the Company experienced 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. However, there was no breach to our systems. 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 increased compared to the same period of 2011 as a result of normal merit increases, the hiring of additional business development professionals and higher levels of employee incentive payments related to increased loan and deposit volumes. New loans originated during the year-ended December 31, 2012 totaled \$1.3 billion compared to \$1.0 billion in the same period of 2011. The number of full-time equivalent employees decreased 47 positions from 1,442 at December 31, 2011 to 1,395 at December 31, 2012.

Increases in data processing expense can be attributed primarily to increased costs related to the higher level of customer debit card usage as electronic transactions continue to increase year over year.

Collection and repossession expense decreased in 2012 compared to 2011 primarily due to the resolution of certain problem credits.

Although the loss on sale or write-down of assets decreased for the year 2012, it remains high compared to historical levels. The expense for the year 2012 is primarily related to write-downs taken on three OREO properties upon receipt of updated appraisals.

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ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)
Results of Operations 2012 Compared to 2011 (Continued)

Income Tax

The provision for income taxes was \$14.7 million in 2012 compared to a benefit of \$0.4 million in 2011 mostly due to a 280% or \$41.7 million increase in pretax income.

The effective tax rate was 26% for the tax expense in 2012 and 3% for the tax benefit in 2011. We ordinarily 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 consistent level of tax benefits that reduce our tax rate below the 35% statutory rate and the relatively low level of annual pretax income produced a low effective tax rate for 2012 and a tax benefit for 2011.

Financial Condition

First Commonwealth's total assets increased by \$154.3 million in 2012. Loans increased \$161.1 million, or 4%, and investments increased \$28.5 million, or 2%. Factors impacting loan growth include underwriting guidelines which limit geography and size for commercial loans, our goal to manage down large credit relationships, generally weak borrower demand and expected declines in the 1-4 family mortgage loan portfolio. Underwriting guidelines provide little flexibility on exceptions and robust monitoring for loan to value, cash flow coverage, debt/equity and other credit quality measurement tools. Geographic limitations include restricting consumer and small business loans to Pennsylvania counties in which First Commonwealth has a branch or loan production office presence; commercial real estate and commercial loan markets were prescribed within a 250 mile radius of First Commonwealth's headquarters location in Indiana, Pennsylvania. Commercial and industrial loan syndications are unlimited geographically in the United States for select, high quality industry segments in which we have expertise.

In 2005, First Commonwealth implemented a strategic decision to exit the residential mortgage business, satisfying customer requests for these loans through a joint venture or home equity loans. As a result, the residential mortgage portfolio is projected to decline approximately \$60 million annually, consistent with 2012, through regularly scheduled repayments and payoffs. In 2012, the mortgage banking joint venture was terminated and other strategic alternatives for the offering of mortgage related products are currently being evaluated.

During 2012, approximately \$574.8 million in investments securities were called or matured. These securities were higher yielding securities and contributed to the decline in yield earned on the portfolio. As a result, \$354.8 million in asset-backed securities and \$250.6 million in agency securities were purchased in 2012 to help increase earnings from the portfolio with a reduced risk profile.

First Commonwealth's total liabilities increased \$166.8 million, or 3%, in 2012. Deposit growth of \$53.2 million, or 1%, was augmented by an increase in short-term borrowings of \$43.5 million, or 14 % and an increase in long-term debt of \$72.8 million, or 72%.

We periodically utilize short-term and long-term borrowings to fund the origination of new loans as well as the purchase of investments. Long-term borrowings were obtained in 2012 as an asset / liability management strategy to mitigate the risk of higher rates in the future and to take advantage of attractive interest rates in the wholesale funding market. The decrease in interest paid on borrowings as well as lower rates being paid on deposits has helped to mitigate the contracting pressure on the net interest yield on interest-earning assets and interest-bearing liabilities.

Table of Contents**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)
Financial Condition (Continued)**Loan Portfolio

Following is a summary of our loan portfolio as of December 31:

	2012		2011		2010		2009		2008	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
	(dollars in thousands)									
Commercial, financial, agricultural and other	\$ 1,019,822	24%	\$ 996,739	25%	\$ 913,814	22%	\$ 1,127,320	25%	\$ 1,146,411	26%
Real estate construction	87,438	2	76,564	2	261,482	6	428,744	9	528,841	12
Residential real estate	1,241,565	30	1,137,059	28	1,127,273	27	1,202,386	26	1,199,819	27
Commercial real estate	1,273,661	30	1,267,432	31	1,354,074	32	1,320,715	28	1,047,506	24
Loans to individuals	582,218	14	565,849	14	561,440	13	557,336	12	495,800	11
Total loans and leases net of unearned income	\$ 4,204,704	100%	\$ 4,043,643	100%	\$ 4,218,083	100%	\$ 4,636,501	100%	\$ 4,418,377	100%

The loan portfolio totaled \$4.2 billion as of December 31, 2012, reflecting growth of \$161.1 million or 4% compared to December 31, 2011. Loan growth was experienced in all categories, with the majority being recognized in the residential real estate portfolio as a result of a successful promotion related to our installment home equity product. 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 as a result of growth in indirect auto lending.

The majority of our loan portfolio is with borrowers located in Pennsylvania. As of December 31, 2012 and 2011, there were no concentrations of loans relating to any industry in excess of 10% of total loans.

As of December 31, 2012, criticized loans or loans designated OAEM, substandard, impaired or doubtful decreased \$3.5 million, or 1%, from December 31, 2011. Criticized loans totaled \$288.5 million at December 31, 2012 and represented 7% of the total loan portfolio. Additionally, delinquency on accruing loans decreased \$13.7 million, or 39%, at December 31, 2012 compared to December 31, 2011. Of this amount, \$6.7 million relates to delinquent consumer loans which were moved to nonaccrual status while the remainder of the decrease is the result of charge-offs, paydowns or payoffs of the loan balance. As of December 31, 2012, nonaccrual loans increased \$16.0 million, or 2%, compared to December 31, 2011 partially due to the addition of the \$6.7 million of consumer loans moved to nonaccrual status. Total gross charge-offs for the year ended December 31, 2012 were \$17.0 million.

Table of Contents**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)
Financial Condition (Continued)**Loan Portfolio (Continued)

Final loan maturities and rate sensitivities of the loan portfolio excluding consumer installment and mortgage loans and before unearned income at December 31, 2012 were as follows:

	Within One Year	One to 5 Years	After 5 Years	Total
	(dollars in thousands)			
Commercial, financial, agricultural and other	\$ 40,765	\$ 663,575	\$ 210,718	\$ 915,058
Real estate construction	10,308	51,340	25,790	87,438
Commercial real estate	148,222	425,608	699,831	1,273,661
Other	8,959	23,431	72,374	104,764
Totals	\$ 208,254	\$ 1,163,954	\$ 1,008,713	\$ 2,380,921
Loans at fixed interest rates		\$ 261,926	\$ 184,074	
Loans at variable interest rates		902,028	824,639	
Totals		\$ 1,163,954	\$ 1,008,713	

(a) The maturity of real estate construction loans include term commitments that follow the construction period. Loans with these term commitments will be moved to the commercial real estate category when the construction phase of the project is completed.

First Commonwealth has a regulatory established legal lending limit of \$103.7 million to any one borrower or closely related group of borrowers, but has established lower thresholds for credit risk management.

Nonperforming Loans

Nonperforming loans include nonaccrual loans and restructured loans. Nonaccrual loans represent loans on which interest accruals have been discontinued. 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 under terms not available in the market.

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 typically placed in nonaccrual status when there is evidence of a significantly weakened financial condition or principal and interest is 90 days or more delinquent, except for consumer loans which are placed in nonaccrual status at 150 days past due. Interest received on a nonaccrual loan is normally applied as a reduction to loan principal rather than interest income utilizing the cost recovery methodology of revenue recognition.

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 are recognized when a loss is probable and the amount is reasonably estimable.

Table of Contents**ITEM 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**
Financial Condition (Continued)Nonperforming Loans (Continued)

The following is a comparison of nonperforming and impaired assets and the effects on interest due to nonaccrual loans for the period ended December 31:

	2012	2011	2010	2009	2008
	(dollars in thousands)				
Nonperforming Loans:					
Loans on nonaccrual basis	\$ 43,539	\$ 33,635	\$ 84,741	\$ 147,937	\$ 55,922
Loans held for sale on nonaccrual basis	0	13,412	0	0	0
Troubled debt restructured loans on nonaccrual basis	50,979	44,841	31,410	0	0
Troubled debt restructured loans on accrual basis	13,037	20,276	1,336	619	132
Total nonperforming loans	\$ 107,555	\$ 112,164	\$ 117,487	\$ 148,556	\$ 56,054
Loans past due in excess of 90 days and still accruing	\$ 2,447	\$ 11,015	\$ 13,203	\$ 15,154	\$ 16,189
Other real estate owned	\$ 11,262	\$ 30,035	\$ 24,700	\$ 24,287	\$ 3,262
Loans outstanding at end of period	\$ 4,204,704	\$ 4,057,055	(389)		
Warrants extinguished with debt				655	
Warrants issued for litigation settlement				611	
Mandatorily convertible redeemable dividends and preferred stock accretion				(3,070)	
Warrants issued with preferred stock				22,412	
Net Loss	(88,037)			(88,037)	
Foreign currency translation adjustment		(2)		(2)	
Comprehensive Income				(88,039)	
Balances, December 31, 2000	(137,130)	(2)	(318)	89,100	
Issuance of common stock for exercise of stock options				183	
Issuance of common stock for exercise of warrants					
Issuance of common stock for the purchase of software				155	
Vesting of stock options granted below intrinsic value				133	
Accelerated vesting of stock options				49	
Mandatorily convertible redeemable dividends and preferred stock accretion				(15,059)	

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Warrants issued with preferred stock				4,333
Treasury stock received upon				
		cancellation of notes receivable from stockholder		(70)
				<u> </u>
Net loss	(146,068)			(146,068)
Foreign currency translation adjustment		2		2
				<u> </u>
Comprehensive loss				(146,066)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Balance, December 31, 2001	\$ (283,198)	\$	\$ (388)	\$ (67,172)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>

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

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**Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)**

	Year Ended December 31,		
	2001	2000	1999
Cash flows from operating activities:			
Net loss	\$(146,068)	\$(88,037)	\$(35,971)
Adjustments to reconcile net loss to net cash used in operating activities:			

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

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Year Ended December 31,		
	2001	2000	1999
Supplemental disclosure of cash flow information:			
Cash paid for interest	\$ 2,648	\$ 1,592	\$ 1,130
Non-cash investing and financing activities:			
Property and equipment acquired under capital lease obligations	\$ 2,395	\$	\$ 15,944
Increase in additional paid-in capital for stock options granted	\$ 1,051	\$ 2,405	\$ 5,064
Net increase in unearned stock compensation for stock options granted	\$ 133	\$ 2,232	\$ 2,295
Accrued dividends and accretion on preferred stock	\$ 15,059	\$ 3,644	\$ 1,654
Notes receivable issued for common stock	\$ 820	\$	\$
Forgiveness of note receivable issued for common stock	\$ (70)	\$	\$ (106)
Common stock issued for purchase of assets	\$ 155	\$	\$ 60
Treasury stock received upon cancellation of note receivable for common stock	\$ (70)	\$	\$ (318)
Conversion of preferred stock to common stock	\$	\$	\$ 39,914
Beneficial conversion associated with preferred stock issuance	\$ 9,356	\$ 20,027	\$
Warrants extinguished with satisfaction of debt	\$	\$ 655	\$
Warrants issued in litigation settlement	\$	\$ 611	\$
Acquisition of Touch 1			
Assets acquired, net of cash	\$	\$ 85,967	\$
Liabilities assumed	\$	\$ 37,979	\$
Cash acquired	\$	\$ 1,168	\$
Assets acquired in exchange for common stock	\$	\$ 40,201	\$

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

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**Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(All tables are in thousands, except for share and per share data)**

1. NATURE OF BUSINESS

Description of Business

Z-Tel Technologies, Inc. and subsidiaries (Z-Tel or the Company) incorporated in Delaware on January 15, 1998 as Olympus Telecommunications Group, Inc. In March 1998, Olympus Telecommunications Group, Inc. changed its name to Z-Tel Technologies, Inc.

Z-Tel is an emerging provider of advanced, integrated telecommunications services targeted to residential and small business subscribers. Z-Tel offers local and long distance telephone services in combination with enhanced communication features accessible through the telephone the Internet and certain personal digital assistants. Z-Tel offers its Z-LineHOME service in thirty-eight states. Z-Tel actively markets Z-Line HOME in ten states. Z-Tel also provides long-distance telecommunications services to customers nationally.

The Company has incurred significant losses since its inception, resulting in an accumulated deficit at December 31, 2001 of approximately \$283 million. The Company also has long-term debt outstanding of approximately \$16 million. The Company continues to experience negative cash flows from operations, which has historically caused it to be dependent on financing from investors to sustain its activities. Within the last two years, the Company raised net proceeds of approximately \$109.1 million from its initial public offering and approximately \$122.0 million from offerings of mandatorily redeemable convertible preferred stock.

At December 31, 2001, the Company had cash on hand of approximately \$19.0 million. In addition, the Company has an accounts receivable factoring agreement, which provides the Company with up to \$25 million dollars to fund operations. This factoring agreement, although renewable for one-year terms, contractually terminates in July 2002. The Company currently anticipates extending the term of the agreement; however, the extension cannot be assured. Currently, the Company anticipates generating, through normal operations, the cash flows necessary to meet its operating and debt service requirements. If actual results differ materially from the Company's current plan, or if the accounts receivable factoring agreement is not renewed, management believes they have the ability to continue as a going-concern through the implementation of cash management strategies, the reduction of certain discretionary capital and marketing costs or the implementation of a workforce reduction. The Company also may seek additional financing to replace the current factoring agreement. There can be no assurance, however, that the Company will be able to implement its strategies or obtain additional financing under terms favorable to the Company.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated.

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**Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tables are in thousands, except for share and per share data)**

Cash and Cash Equivalents

The Company considers all highly liquid investments with original maturity dates of three months or less to be cash equivalents.

Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets consist primarily of prepaid maintenance and support contracts, advances to suppliers and certain disputes with vendors that require payment and the filing of a dispute claim.

Property and Equipment

Property and equipment are recorded at historical cost. Depreciation and amortization are calculated on a straight-line basis over the assets' useful life. Maintenance and repairs are expensed as incurred, while renewals and betterments are capitalized. Upon the sale or other disposition of property, the cost and related accumulated depreciation are removed from the accounts and any gain or loss is recognized in operations. Effective January 1, 1999, the Company adopted Statement of Position (SOP) 98-1, Accounting for the Cost of Computer Software Developed or Obtained for Internal Use. SOP 98-1 requires computer software costs related to internal software that is incurred in the preliminary project stage to be expensed as incurred. When the capitalization criteria of SOP 98-1 have been met, costs of developing or obtaining internal-use computer software are capitalized. The Company capitalized approximately \$3.9 and \$3.1 million of employee salary costs for internally developed software for the years ended December 31, 2001 and 2000, respectively. Internal use software is included as a component of property and equipment on the consolidated balance sheet.

Long-Lived Assets The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the discounted cash flows. The Company recognized an impairment of \$59.2 million related to goodwill acquired from the acquisition of Touch 1 as a result of the sale of our telemarketing centers in 2001. As stated under New Accounting Pronouncements, the Company adopted Statement of Financial Accounting Standard (SFAS) No. 144 effective January 1, 2002.

Intangible Assets

Intangible assets consist of customer lists and goodwill resulting from our acquisition of Touch 1 in 2000 (see Footnote 3 Acquisition of Touch 1). The customer lists and goodwill are amortized over five and twenty years, respectively, using the straight-line method and the intangibles are reviewed for impairment as outlined in our long-lived assets policy above. The goodwill was written-down to zero value in 2001. As noted under New Accounting Pronouncements, the Company adopted SFAS No. 142 effective January 1, 2002.

Investments

Included in investments are available-for-sale securities and investments accounted for utilizing the cost method of accounting, for those investments without a readily identifiable market. In accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities securities that are available for sale are reported at fair value, if a readily identifiable market exists, with changes in the fair

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tables are in thousands, except for share and per share data)

value from period to period included as a separate component of comprehensive income in equity. At December 31, 2000 the Company had approximately \$0.4 million in investments, included in other assets, accounted for at cost since no readily identifiable market existed for these investments. Z-Tel received gross proceeds of approximately \$3.5 million and recognized a gain on available for sale securities in the amount of approximately \$2.7 million for the year ended December 31, 2000. The Company had no investments or sales of investments for the years ended December 31, 2001 and 1999.

Income Taxes

The Company utilizes the asset and liability method of accounting for income taxes. Under this method, deferred income taxes are recorded to reflect the tax consequences on future years of differences between the tax basis of assets and liabilities and their financially reported amounts at each year-end based on enacted laws and statutory rates applicable to the periods in which differences are expected to affect taxable income. A valuation allowance is provided against the future benefits of deferred tax assets if it is determined that it is more likely than not that the future tax benefits associated with the deferred tax asset will not be realized.

Stock-Based Compensation

The Company applies the provisions of Accounting Principles Board (APB) Opinion No. 25 and consequently recognizes compensation expense over the vesting period for grants made to employees and directors only if, on the measurement date, the market price of the underlying stock exceeds the exercise price. For stock options granted to non-employees, the Company utilizes the Emerging Issues Task Force (EITF) 96-18, Account for Equity Instruments that are Issued to Other Than Employees Acquiring or in Conjunction with Selling Goods or Services. The Company recognizes expense over the vesting period of the grants made to non-employees based on utilizing the Black-Sholes stock valuation model to calculate the value of the option on the measurement date.

For employee stock options the Financial Accounting Standards Board (FASB) issued SFAS No. 123, Accounting for Stock-Based Compensation requiring entities to recognize as an expense, over the vesting period, the fair value of the options or utilize the accounting for employee stock options used under APB 25. Therefore, under SFAS 123 the Company provides the required pro forma net income and earnings per share disclosures for grants made as if the fair value method defined in SFAS No. 123 had been applied.

Revenue Recognition

Revenues are recognized when earned. Revenues related to long distance and carrier access service charges are billed monthly in arrears, and the associated revenues are recognized in the month of service. In June 1999, the Company began offering its bundled service, Z-LineHOME, to consumers. Charges for Z-LineHOME service are billed monthly in advance and the Company recognizes revenues for this service ratably over the service period, which management believes approximates the actual provision of services.

Advertising

Advertising costs are expensed as incurred. Included in sales and marketing expenses are advertising costs of approximately \$7.1, \$8.4 and \$7.1 million for the years ended December 31, 2001, 2000 and 1999, respectively.

Foreign Currency Translation

The assets and liabilities of the Company's foreign subsidiary, whose functional currency is other than the U.S. Dollar, are translated at the exchange rates in effect on the reporting date, and income and expenses

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tables are in thousands, except for share and per share data)

are translated at the weighted average exchange rate during the period. The net effect of translation gains and losses is not included in determining net income but is included in accumulated other comprehensive income, which is reflected as a separate component of shareholder's equity. Foreign currency translation gains and losses are included in determining net income. Such gains and losses are not material for any period presented. The Company's only foreign subsidiary was sold during 2001.

Concentrations

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents and accounts receivable. The Company places its cash and cash equivalents in financial institutions considered by management to be high quality. The Company maintains cash balances at financial institutions in excess of the \$100,000 insured by the Federal Deposit Insurance Corporation ("FDIC"). The Company had approximately \$8.1 and \$42.9 million invested in interest bearing money market and short-term fixed income investments that are not insured by the FDIC at December 31, 2001 and 2000, respectively. The Company has not experienced any losses in these accounts and believes it is not exposed to any significant credit risk on cash balances.

During the normal course of business, the Company extends credit to residential customers residing in the United States. The Company's services were introduced first into the states of New York and Texas, which has resulted in a concentration of credit to residential customers in these states. The Company believes its credit policies, collection procedures and allowance for doubtful accounts minimize the exposure to significant credit risk of accounts receivable balances.

The Company relies upon the Regional Bell Operating Companies (RBOCs) for provisioning of customers and the RBOCs are the primary suppliers of local central office switching and local telephone lines. Global Crossing Ltd is the primary supplier for the Company's long-distance calling. The Company has not incurred any material impact to its operations or financial statements as a result of the Global Crossing Ltd. Chapter 11 bankruptcy filing.

The Company relies upon two separate service providers for provisioning and billing services essential to support the Company's operations.

Segment Reporting

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, requires that the Company report financial and descriptive information about reportable segments, and how these segments were determined. The Company determines the allocation and performance of resources based on total operations. Based on these factors, management has determined that the Company operates as one segment as defined by SFAS No. 131 during all periods presented.

Financial Instruments

The recorded amounts of cash and cash equivalents approximate fair value due to the short-term nature of these instruments. The Company has determined that due to the interest rates and short-term nature of the capital lease obligation, the fair value approximates the value recorded. The Company has determined that the long-term debt assumed through acquisition is recorded at fair value. The interest rates were adjusted to the current market rate for purchase accounting treatment and the Company believes the debt is properly recorded at fair value.

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**Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tables are in thousands, except for share and per share data)**

Management's Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. Estimates also affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

New Accounting Pronouncements

In July 2001, the FASB issued SFAS No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS 141 addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination, whether acquired individually or with a group of other assets, and the accounting and reporting for goodwill and other intangible assets subsequent to their acquisition. These standards require all future business combinations to be accounted for using the purchase method of accounting. Goodwill will no longer be amortized regularly but instead will be subject to impairment tests at least annually. The Company adopted SFAS No. 141 and SFAS No. 142 on a prospective basis as of January 1, 2002.

As of December 31, 2001, Z-Tel has \$5.9 million of intangible assets, net of accumulated amortization. The net amount recorded for goodwill is zero at December 31, 2001. Accordingly, the Company does not expect the adoption of SFAS No. 142 to have a material impact on its future operations and statement of position.

In June 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. The statement provides accounting and reporting standards for recognizing obligations related to asset retirement costs associated with the retirement of tangible long-lived assets. Under this statement, legal obligations associated with the retirement of long-lived assets are to be recognized at their fair value in the period in which they are incurred if a reasonable estimate of fair value can be made. The fair value of the asset retirement costs is capitalized as part of the carrying amount of the long-lived asset and subsequently allocated to expense using a systematic and rational method over the asset's useful life. Any subsequent changes to the fair value of the liability due to passage of time or changes in the amount or timing of estimated cash flows is recognized as an accretion expense. The Company will be required to adopt this statement no later than January 1, 2003. The Company is currently assessing the impact of this statement on its results of operations, financial position and cash flows.

In October 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, which is effective for fiscal years beginning after December 15, 2001. This statement supercedes FASB Statement No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of. However, SFAS 144 retains the fundamental provisions of SFAS No. 121 for the recognition and measurement of the impairment of long-lived assets to be held and used and the measurement of long-lived assets to be disposed of by sale. Impairment of Goodwill is not included in the scope of SFAS No. 144 and will be treated in accordance with the accounting standards established in SFAS No. 142, Goodwill and Other Intangible Assets. According to SFAS No. 144, long-lived assets are to be measured at the lower of carrying amount or fair value less cost to sell, whether reported in continuing or discontinued operations. The statement applies to all long-lived assets, including discontinued operations, and replaces the provisions of APB Opinion No. 30, Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, for the disposal of segments of a business. The Company adopted this statement on January 1, 2002 on a prospective basis. The adoption of this standard did not have a material impact on its results of operations, financial position and cash flows.

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Reclassification

Certain amounts in the December 31, 2000 and 1999 financial statements have been reclassified to conform to the December 31, 2001 presentation.

3. ACQUISITION OF TOUCH 1

The Company completed the acquisition of Touch 1 Communications, Inc. (Touch 1), a reseller of long distance service to subscribers throughout the United States, on April 14, 2000. The purchase price for Touch 1 consisted of 1.1 million shares of the Company's common stock at a price of \$35.71 per share, approximately \$9.0 million in cash, and approximately \$1.0 million in transaction and related fees. The acquisition of Touch 1 was accounted for using the purchase method of accounting and, accordingly, the results of operations of Touch 1 for the period from April 1, 2000 (the closing date for accounting purposes) are included in the accompanying consolidated financial statements. The acquisition of Touch 1 resulted in approximately \$67.8 million of intangible assets. The intangible assets were comprised of approximately \$9.2 million for customer lists and approximately \$58.6 million for goodwill, which were being amortized, on the straight line basis, over periods of five and twenty years, respectively. As disclosed in Footnote 7 Asset Impairment, during 2001, the Company recorded an impairment of assets acquired of approximately \$59.2 million, approximately \$54.9 million related to goodwill associated with the Touch 1 purchase. The Company recorded \$3.3 and \$3.6 million of amortization of the intangible assets for the year ended December 31, 2001 and 2000, respectively.

Touch 1 and its wholly owned subsidiary, direcTEL Inc. (direcTEL), filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code on June 29, 1999 and July 9, 1999, respectively, in the United States Bankruptcy Court for the Southern District of Alabama (the Bankruptcy Court). The Bankruptcy Court entered an order confirming the joint plan of reorganization of Touch 1 and direcTEL on August 6, 1999 and entered final decrees closing the direcTEL case on October 5, 2000 and the Touch 1 case on October 30, 2000.

4. ACCOUNTS RECEIVABLE AGREEMENT

In July 2000, the Company entered into an accounts receivable agreement with RFC Capital Corporation, a division of Textron, Inc. (RFC), providing for the sale of certain of the Company's accounts receivable to RFC. RFC has agreed to purchase up to \$25.0 million of the Company's accounts receivable. In July 2001, the Company extended its agreement with RFC under substantially similar terms for an additional year. The RFC agreement, although renewable for one-year terms, contractually terminates in July 2002. The purchase of the receivables is at the option of RFC and they utilize selection criteria to determine which receivables will be purchased. The Company sells receivables to RFC at a 32% discount; this rate is negotiable and may change according to collection experience. Our collection percentage for receivables sold to RFC was 89% for the year ended December 31, 2001. The Company receives an additional payment from RFC for servicing the assets in an amount equal to every dollar collected over the advance rate, less certain fees. The accounts receivable agreement does not have a minimum receivable sales requirement.

Z-Tel has sold approximately \$156.3 and \$1.4 million of receivables to RFC, for net proceeds of approximately \$106.5 and \$0.8 million, for the years ended December 31, 2001 and 2000, respectively. A net receivable servicing asset of approximately \$12.9 and \$0.4 million is included in the accounts receivable balance at December 31, 2001 and 2000, respectively. The Company recorded costs related to the agreement of approximately \$1.1 million for the year ended December 31, 2001. Included in accounts payable and accrued liabilities are advances for unbilled receivables in the amount of \$3.5 million at December 31, 2001. Z-Tel is responsible for the continued servicing of the receivables sold.

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5. ACCOUNTS RECEIVABLE WRITE-OFF

During the second quarter of 2001, management performed a detailed analysis of accounts receivable and also reviewed its credit policies relating specifically to acceptance and provisioning of service to new customers. As a result of the analysis and subsequent change in credit policy, the Company switched its focus from collection efforts on overdue and delinquent account balances to a stringent credit policy surrounding customer acceptance and a collection effort focused on fewer delinquent accounts. The detailed analysis and change in credit policy lead the Company to write-off delinquent receivables and revise the estimates used to develop the allowance for doubtful accounts in the current and future periods.

As a result of the receivables write-off, an additional approximately \$29.9 million of bad debt expense was recorded in the second quarter of 2001 and is included in general and administrative expense for the year ended December 31, 2001. The Company had write-offs of accounts receivables totaling approximately \$43.9 and \$21.2 million for the years ended December 31, 2001 and 2000, respectively.

6. PROPERTY AND EQUIPMENT

At the respective dates, property and equipment consist of the following:

	Depreciable Lives	2001	2000
Switching equipment	5-10	\$ 14,589	\$ 15,635
Computer equipment	5-10	28,263	25,068
Software	3	35,462	23,832
Furniture and office equipment	5-10	9,537	9,174
Leasehold improvements	3-15	4,192	4,186
Land and building	20-30	6,611	4,123
Construction-in-progress		792	2,371
		99,446	84,389
Less accumulated depreciation and amortization		43,215	25,189
		\$ 56,231	\$ 59,200

Depreciation expense related to property and equipment amounted to approximately \$11.5, \$8.2 and \$2.0 million for the years ended December 31, 2001, 2000 and 1999, respectively. Amortization expense related to software amounted to approximately \$8.5, \$5.4 and \$2.4 million for the years ended December 31, 2001, 2000 and 1999, respectively.

At the respective dates, assets acquired under capital leases, included in property and equipment, consist of the following:

	2001	2000
Software	\$ 704	\$
Computer equipment	1,288	
Furniture and office equipment		95
	1,992	95
Less accumulated depreciation and amortization	312	27
	\$ 1,680	\$ 68

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7. ASSET IMPAIRMENT

In accordance with SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, management assesses on an ongoing basis if there has been impairment in the carrying value of its long-lived assets. As a result of management's decision in the second quarter to reduce telemarketing efforts, a majority of the operations and assets of telemarketing centers acquired from Touch 1 were either voluntarily closed or sold. On June 30, 2001, the telemarketing centers sold accounted for approximately \$1.0 million in property, plant and equipment. For these assets, the Company received 270,000 shares of preferred stock of the privately-held acquiring company and a note receivable of approximately \$0.5 million. The loss recorded from this transaction equated to approximately \$1.0 million.

As a result of the decision to reduce telemarketing efforts noted above and the subsequent transactions, management performed an assessment of the value of the intangible assets recorded in the Touch 1 acquisition. In the second quarter of 2001, it was determined that undiscounted future cash flows over the remaining amortization period of certain intangible assets indicated that the value assigned to the intangible asset might not be recoverable. Therefore, the Company undertook an effort to determine the amount of expense to be recorded relating to the impairment.

The carrying value of the goodwill and identifiable intangibles recorded on the books approximated \$61.7 million prior to the impairment analysis. The Company calculated the fair value of the intangibles by performing a discounted cash flow analysis related to the remaining assets acquired in the Touch 1 purchase. As the Company determined that it would effectively cease any telemarketing efforts in the future, the sole remaining assets from the Touch 1 purchase were certain amounts of property, plant and equipment and intangibles (consisting of customer lists and goodwill) acquired in the Touch 1 transaction. Assuming a monthly attrition rate of 4.5% and a discount rate of 17.5% over an 18 month period, it was determined that the remaining operations acquired from Touch 1 had a liquidation value which approximated the carrying value of the customer lists acquired from Touch 1. At June 30, 2001, the carrying value of the identifiable intangibles associated with the customer lists was approximately \$6.8 million. Therefore, during the second quarter of 2001, the Company recorded a loss of \$54.9 million, the difference between the carrying value of all intangibles and the carrying value of the customer lists.

For the year ended December 31, 2001, the Company recorded an additional \$4.3 million of impaired asset charges, composed of \$3.0 million relating to unrealizable software and development projects, \$0.9 million of telemarketing property and equipment and \$0.4 million of securities deemed to be worthless. As of December 31, 2001, the Company has approximately \$5.9 million of net intangible assets related to customer lists.

8. OTHER ASSETS

At the respective dates, other assets consist of the following:

	<u>2001</u>	<u>2000</u>
Deposits	\$3,625	\$2,656
Certificates of deposit, restricted	647	573
Interest receivable from stockholders	176	111
Other	218	413
	<u>\$4,666</u>	<u>\$3,753</u>

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The certificates of deposit are pledged as collateral on outstanding letters of credit in the amount of approximately \$0.6 million at December 31, 2001 and 2000, related to lease obligations on two of the Company's office spaces.

9. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

At the respective dates, accounts payable and accrued liabilities consist of the following:

	<u>2001</u>	<u>2000</u>
Trade accounts payable	\$33,602	\$32,679
	2,070	3,982
Dividend payable to preferred shareholders	4,128	
Accrued sales and use tax	3,644	2,239
Accrued rent	1,533	1,218
Other accrued liabilities	4,645	4,575
	<u>\$49,622</u>	<u>\$44,693</u>

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10. LONG-TERM DEBT

Long-term debt consists of the following:

	2001	2000
Related Parties:		
Note Payable to Corman Elegre Capital L.L.C (Corman Elegre), customer base pledged as collateral, balloon payment due May 2001, interest rate at rate at prime plus one and one-half percent, which was 11% at December 31, 2000	\$	\$ 3,000
Note payable to Corman Elegre, customer base pledged as collateral payable in monthly installments, due September, 2004, interest rate at 6%	7,595	9,868
Note payable to First Revocable Trust of W. F. Corman, unsecured payable in monthly installments, due September 2004, interest rate at 6%	472	612
Note payable to James F. Corman, unsecured, payable in monthly installments, due September 2004, interest rate at 6%	159	211
Unrelated Parties:		
Note payable to Franklin Investment Funds, unsecured, payable in monthly installments, due September 2004, interest rate of 6%	3,271	4,250
Note payable to First National Bank of Atmore, unsecured, personally guaranteed by James F. Corman, payable in monthly installments, due September 2004, interest rate at 6%	439	570
Notes payable to pre-petition creditors (trade vendors), unsecured, payable in monthly installments, due September 2004, interest rate at 6%	1,169	1,475
Notes payable to pre-petition creditors (trade vendors), priority unsecured, payable in monthly installments, due September 2004 , interest rate at 6%	304	417
	<u>13,409</u>	<u>20,403</u>
Less: Current portion	<u>(4,880)</u>	<u>(7,623)</u>
	<u>\$ 8,529</u>	<u>\$ 12,780</u>

Operating Leases

The Company has entered into various non-cancelable operating leases for equipment and office space with monthly payments through the year 2009. Included in general and administrative expense is rental expense relating to operating leases of approximately \$2.8, \$1.7 and \$1.6 million for the years ended December 31, 2001, 2000 and 1999, respectively. Sales and marketing expense includes \$0.6 million of rental expense relating to operating leases for both years ended December 31, 2001 and 2000.

Capital Leases

The Company entered into various capital lease obligations during 2001 that had effective interest rates ranging from 8.0% to 10.7%, with three capital leases remaining with payments through 2001.

Future minimum lease payments under non-cancelable operating and capital leases and long-term debt as of December 31, 2001 are as follows:

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Year Ending December 31,	Operating Leases	Capital Lease Obligations	Long-Term Debt
2002	\$ 3,475	\$ 1,635	\$ 4,880
2003	3,562	725	4,403
2004	3,654	343	4,063
2005	2,531		63
2006	1,389		
Thereafter	3,879		
Less amount representing estimated executor costs (taxes, etc.), including profit thereon, included in minimum lease payments		99	
Net minimum payments	18,490	2,604	13,409
Less amount representing interest on obligations under capital lease		246	
Present value of minimum lease payments (including approximately \$1,425 due within one year)		\$2,358	

11. MANDATORILY REDEEMABLE CONVERTIBLE PREFERRED STOCK

In January 2000, the Company paid \$1.4, \$0.2, and \$0.2 million to the Series A, B, and C Preferred shareholders, respectively, in satisfaction of an 8% cumulative dividend as all shares were converted to common stock.

In July 2000, the Company filed a Certificate of Designation authorizing the issuance of 5.0 million shares of \$.01 par value Series D Convertible Preferred Stock (Series D Preferred). The Company received aggregate proceeds of approximately \$56.3 million in connection with the sale of 4,688,247 shares of Series D Preferred at a price of \$12.00. The deal costs associated with the transaction were approximately \$0.4 million. The Series D Preferred is convertible at an original conversion price of \$12.00, which price is subject to adjustment for such items as; (i) a dividend or distribution to common shareholders (whether such dividend or distribution is in stock, securities or other property), (ii) a stock split, (iii) a stock combination, (iv) a reclassification of the common stock, (v) the issuance of stock or securities convertible into or exercisable for common stock of the Company at a price that is less than the adjusted conversion price and other events that would cause dilution of ownership to the Series D Preferred stock. As a result of certain of these events the conversion price at December 31, 2001 is \$8.79. The Series D Preferred is convertible into common stock at the option of the holder (*i.e.*, initially convertible on a one-for-one basis); however, there are certain circumstances that provide for a forced conversion of the stock by the Company. Series D Preferred is mandatorily redeemable in 2008, has an 8% cumulative dividend payable at times in cash and at times in-kind with additional Series D Preferred and has certain liquidation preferences and voting rights. Each purchaser of Series D Preferred received a warrant to purchase a number of shares of Z-Tel common stock equal to one-half of the amount of Series D Preferred purchased by such investor. Each warrant is exercisable at a price of \$13.80 per share subject to certain adjustments that have lowered the exercise price to \$10.52 per share, at December 31, 2001.

In October 2000, the Company paid \$0.9 million to the Series D Preferred shareholders in satisfaction of the 8% cumulative dividend.

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In November 2000, the Company filed a Certificate of Designation authorizing the issuance of approximately 6.3 million shares of \$.01 par value Series E Convertible Preferred Stock (Series E Preferred). The Company received proceeds of approximately \$50.0 million in connection with the sale of 4,166,667 shares of Series E Preferred at a price of \$12.00. The purchaser of Series E Preferred received a warrant to purchase a number of shares of Z-Tel common stock equal to one-half of the amount of Series E Preferred purchased by such investor. These warrants are exercisable at a price of \$13.80 per share subject to certain adjustments that have lowered the exercise price to \$8.71 per share, at December 31, 2001. Series E Preferred is convertible at an original conversion price of \$12.00, which price is subject to adjustment for such items as (i) a dividend or distribution to common shareholders (whether such dividend or distribution is in stock, securities or other property), (ii) a stock split, (iii) a stock combination, (iv) a reclassification of the common stock, (v) the issuance of stock or securities convertible into or exercisable for common share of the Company at a price that is less than the adjusted conversion price, and (vi) other events that would cause dilution in the ownership of the holders of the Series E Preferred stock. As a result of these events the conversion price at December 31, 2001 is \$8.42. The Series E Preferred is convertible into common stock at the option of the holder (*i.e.*, initially convertible on a one-for-one basis); however, there are certain circumstances that provide for a forced conversion of the stock by the Company. Series E Preferred is mandatorily redeemable 8 years from the original issue date, has an 8% cumulative dividend payable in cash and has certain liquidation preferences and voting rights.

In July 2001, the Company filed a Certificate of Designation authorizing the issuance of 175 shares of Series G junior convertible preferred stock (Series G Preferred). On July 2 and August 3, 2001, the Company issued an aggregate of 175 shares of Series G Preferred for aggregate proceeds of \$17.5 million, initially convertible into 11,739,970 shares of common stock, at a conversion price of \$1.49, subject to adjustment for such items as; (i) a dividend or distribution to common shareholders (whether such dividend or distribution is in stock, securities or other property), (ii) a stock split, (iii) a stock combination, (iv) a reclassification of the common stock, (v) the issuance of stock or securities convertible into or exercisable for common stock of the Company at a price that is less than the adjusted conversion price and upon the occurrence of certain other events that would cause dilution in the ownership of the holders of the Series G Preferred. There is no change in the conversion price at December 31, 2001. In conjunction with the issuance of the Series G Preferred, the Company issued warrants to purchase 3,000,000 shares of common stock at an exercise price of \$0.01 per share. The Series G Preferred was redeemable on December 31, 2001 unless shareholder approval was obtained. Once shareholder approval was obtained the Series G Preferred is mandatorily redeemable 5 years from September 18, 2001. The Series G Preferred has a 12% cumulative dividend, is convertible at the option of the holder and has certain liquidation rights; however, there are certain circumstances that provide for a automatic conversion of the Series G Preferred.

In accordance with generally accepted accounting principles, the Company recorded a deemed dividend of approximately \$2.3 million, which results from the value assigned to the warrants and a beneficial conversion feature associated with the Series G Preferred transaction. These deemed dividends were originally accreted over an expected life through December 31, 2001 (the earliest redemption date). Once shareholder approval was obtained on October 30, 2001, the remaining balance of \$1.2 million has been and will continue to be accreted over the remaining 5-year redemption period.

As a result of certain anti-dilution clauses in the Series D Preferred stock agreement, the issuance of Series G Preferred triggered an additional beneficial conversion feature related to the Series D Preferred agreement. The deemed dividend of approximately \$7.8 million was accreted immediately, in the third quarter of 2001.

In accordance with EITF 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios, APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants, EITF 00-27, Application of Issue No. 98-5 to Certain Convertible Instruments and SFAS No. 128 Earnings Per Share the Company has recorded non-cash charges relating to a beneficial conversion, cumulative dividends and preferred stock accretion. The

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Company recorded preferred stock dividends and accretion of \$15.1, \$3.6, and \$1.7 million for the years ended December 31, 2001, 2000 and 1999, respectively. The Company recorded a deemed dividend related to a beneficial conversion feature in the amounts of approximately \$9.4, \$20.0 and \$0.0 for the years ended December 31, 2001, 2000 and 1999, respectively.

During the year ended December 31, 2000 the Company used the stated conversion price method, included in EITF 98-5, for the original calculation of a beneficial conversion of approximately \$7.4 million during the third quarter of 2000. The beneficial conversion related to the issuance of Series D Preferred. EITF 98-5 allowed for the usage of the stated conversion price method for the purpose of calculating beneficial conversions until the fourth quarter of 2000. In November 2000, EITF 00-27, required that all beneficial conversions be calculated using the accounting conversion price method. Z-Tel recorded a cumulative catch-up adjustment of approximately \$12.6 million in the fourth quarter of 2000 since the SEC required retroactive application of this method.

The recording of the beneficial conversion feature and the resulting preferred stock accretion is the result of calculating the accounting conversion price through a fair value allocation of the net proceeds received in the preferred stock offerings between the preferred stock and the warrants issued. This required the use of the Black-Scholes valuation model to calculate the fair value on a per share or warrant basis for both the Series D, E and G Preferred. The beneficial conversion and resulting preferred stock accretion and the cumulative dividend are included in the calculations of the net loss attributable to common stockholders and the Company's net loss per share calculation.

12. COMMON STOCK

In connection with the closing of the IPO, the Company amended its Articles of Incorporation to provide the authority to issue 150,000,000 shares of common stock and 50,000,000 shares of preferred stock, both with a \$.01 par value.

The board of directors has declared no dividends on common stock since January 15, 1998 (Inception).

On December 15, 1999, the Company filed its initial public offering (IPO) of 6,900,000 shares (including the underwriters over-allotment option) of its common stock at \$17.00 per share. Net proceeds to the Company aggregated approximately \$109.1 million after underwriter discount and commissions. All of the mandatorily redeemable convertible preferred stock outstanding at the date of the IPO was converted into 10,476,256 shares of common stock as of the closing date of the offering.

On February 19, 2001, the Board of Directors of the Company adopted a Stockholders Rights Agreement (the Plan) designed to deter coercive takeover tactics and prevent an acquirer from gaining control of the Company without engaging in negotiation with the Board of Directors of the Company.

Under the terms of the plan, preferred stock purchase rights were distributed as a dividend at the rate of one right for each share of common stock, par value \$0.01 per share, of the Company (and a corresponding number of rights for each outstanding share of the Company's Series D Preferred and Series E Preferred Stock) outstanding at the close of business on March 7, 2001. Until the rights become exercisable, additional common stock or Series D Preferred or Series E Preferred issued by the Company will also have one right attached.

The rights will become exercisable only upon certain triggering events whereby certain persons or groups of persons have expressed the intent to acquire at least 15% or more of the voting power of the outstanding common shares.

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Upon the occurrence of a triggering event, each right will entitle holders to buy one one-thousandth of a share of Series F Junior Participating Preferred Stock of the Company, par value \$0.001 per share, at an exercise price of \$45 per one-thousandth of a share, subject to adjustment. Each holder of a right will thereafter have the right to receive, in lieu of Series F Junior Participating Preferred Stock and upon payment of the exercise price, common stock (or in certain circumstances, cash, property or other securities of the Company) having a value equal to two times the exercise price of the right. The Company, except as otherwise provided in the plan, will generally be able to redeem the rights at \$0.001 per right at any time on or prior to a triggering event. The rights will expire on February 19, 2011, unless earlier redeemed by the Board of Directors.

13. INCOME TAXES

The Company accounts for income taxes under SFAS No. 109, Accounting for Income Taxes. Deferred income tax assets and liabilities are determined based upon differences between financial reporting and tax basis of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse.

A reconciliation of the difference between the effective income tax rate and the statutory federal tax rate follows:

	<u>2001</u>	<u>2000</u>
Tax at U.S. statutory rate	\$(51,145)	\$(30,813)
State taxes, net of federal benefit	(2,698)	(2,565)
Goodwill amortization	19,725	768
Change in valuation allowance	36,779	32,218
Other	(2,661)	392
	<u>\$</u>	<u>\$</u>

Significant components of the Company deferred tax assets are liabilities are as follows:

	<u>2001</u>	<u>2000</u>
Current deferred tax assets:		
Accounts receivable	\$ 6,484	\$ 3,430
Other	127	214
Noncurrent deferred tax assets:		
Net operating loss carryforward	98,817	65,358
Deferred compensation	538	468
Other	674	505
	<u>106,640</u>	<u>69,975</u>
Gross deferred tax assets	106,640	69,975
Less: Valuation allowance	(100,438)	(63,659)
	<u>6,202</u>	<u>6,316</u>
Noncurrent deferred tax liabilities:		
Property and equipment	(3,943)	(3,362)
Intangible assets	(2,259)	(2,954)
	<u>\$</u>	<u>\$</u>
Net deferred tax asset	<u>\$</u>	<u>\$</u>

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Generally accepted accounting principles require a valuation allowance to reduce the deferred tax assets reported if, based on the weight of the evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. After consideration of all of the evidence, both positive and negative, management has determined that a valuation allowance of approximately \$100.4 and \$63.6 million is necessary at December 31, 2001 and 2000, respectively.

At December 31, 2001 and 2000, the Company's net operating loss carryforward for federal income tax purposes is approximately \$260.0 and \$172.0 million, respectively, expiring in various amounts from 2018 through 2021. The net operating loss carryforwards may be subject to certain tax law provisions that limit the utilization of net operating losses that were generated in pre-acquisition years and any changes in ownership.

14. COMMITMENTS AND CONTINGENCIES

The Company has disputed billings and access charges to and from certain inter-exchange carriers (IXCs) and incumbent local exchange carriers (ILECs). The Company contends the invoicing and billings of access charges are not in accordance with the interconnection, service level, or tariff agreements entered between the Company and certain IXCs and ILECs. The Company has not paid for a portion of these disputes and management believes that the Company will prevail in these disputes. At December 31, 2001, the disputed amount not recorded in the financial statements was approximately \$5.6 million.

In August 2000, the Company entered into an agreement with a service firm to outsource customer provisioning through electronic bonding with ILECs. The Company is committed to minimum cash payments, subject to certain adjustments, of approximately \$7.7 and \$9.0 million for the years ended December 2003 and 2004, respectively. The payments of these fees are subject to the successful completion by the service firm of certain obligations in the future. This contract provides for various termination arrangements with related severance fees. During 2001 and 2000 we made payments under the agreement totaling \$6.3 and \$0.5 million, respectively.

15. RELATED PARTY TRANSACTIONS

During 1998, various executives of the Company issued full recourse promissory notes, totaling approximately \$3.3 million to the Company in connection with the purchase of 2,929,575 shares of common stock. These notes are collateralized by the shares of common stock acquired with the notes, and the Company holds those shares in escrow. The accompanying consolidated financial statements include the notes as a decrease in stockholders' equity. The outstanding notes receivable related to these notes at December 31, 2001 and 2000 are approximately \$0.8 and \$0.9 million, respectively. The Company received no payments in 2001 and approximately \$0.8 million in 2000. The principal balance of the notes and the related accrued interest (8% per annum) were originally due December 31, 2001, however, see Footnote 20 - Subsequent Events, for discussion of the extension of the outstanding notes until December 31, 2002. Interest income on these notes receivable was \$0.1, \$0.1 and 0.3 million for the years ended December 31, 2001, 2000 and 1999, respectively.

In September 1999, the Company cancelled approximately \$0.3 million of notes receivable and reacquired 279,675 shares of common stock at \$1.14 per share from an employee. These shares are presented as treasury shares, at cost.

In May 2000, as a result of a change of control provision that was triggered by the acquisition of Touch 1, Touch 1 purchased a building used to house its technology infrastructure from its lessor, Brookwood, L.L.C., for approximately \$3.5 million from a limited liability company of which an executive of Z-Tel is a significant shareholder.

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tables are in thousands, except for share and per share data)

During 2000, the Company made total payments of approximately \$5.6 million, exclusive of approximately \$3.5 million to purchase a building as described in the above paragraph, to an executive and several entities affiliated with this executive pursuant to debt and lease agreements. The entities and the various debt terms are outlined in Footnote 10 - Long-Term Debt, under Related Party, with the total amounts owed to each of the entities for each of the years ended December 31, 2001 and 2000.

During 2000, a member of the Board of Directors of the Company received approximately \$0.2 million and an option to purchase 12,500 shares of common stock at \$7.06 from Breckenridge Securities Corporation (BSC), which fee was paid from amounts paid by the Company to BSC in connection with services provided in conjunction with the issuances of Series D and Series E Preferred. The member of the Board of Directors entered into this agreement prior to being appointed to the Board.

During 2000, the Company made payments of \$0.1 million in rental payments to Olympus Management Group, Inc., an entity 100% owned by a Company executive.

In December 2000, the Company agreed to a guarantee of three employees' margin loans. Each employee executed an agreement with the Company in which each pledges to the Company a security interest in all shares of the Company's common stock they own as well as in all of their other tangible and intangible property. In addition, each employee entered into a Secured Promissory Note providing that, should the creditor who made the margin loan to these employees draw any amounts on the Company guarantee, such amounts would be considered advances under a secured promissory note and would bear interest until paid. As of December 31, 2001 two of the three employees fulfilled their obligations leaving approximately \$1.1 million of the guarantee.

In January 2001, the Company accelerated the vesting of 50,000 stock options granted to an executive as part of his severance agreement. This acceleration resulted in the employee being fully vested in stock options with a strike price of \$3.64 when the stock was trading at \$4.50. The Company recorded approximately \$0.1 million in general and administrative expense as a result of this transaction.

In February 2001, the Company, made a loan to an employee in the amount of 0.1 million. The interest rate of the note is 9.5% and it is payable as a balloon payment on February 23, 2003. This note is collateralized by any and all stock options, rights to salary and wages, and all property personal, tangible, and intangible of the employee.

In June 2001, the Company, as part of an executive severance agreement, paid an executive approximately \$0.3 million. This same executive received an interest free loan of approximately \$0.8 million, utilized to exercise stock options to purchase 187,000 shares of common stock. This note is collateralized by the shares of common stock acquired with the note, and the Company holds those shares as security.

In August 2001, the Company cancelled approximately \$0.7 million of notes receivable and reacquired 61,875 shares of common stock at \$1.14 per share from the employee. These shares are presented as treasury shares, at cost.

In September and October 2001, the Company loaned an employee an aggregate of \$0.1 million. The interest rate of the note is 6.5% and is payable as a balloon payment on June 13, 2002. This note was for relocation of the employee. There is no collateral pledge for this note.

16. EMPLOYEE BENEFIT PLAN

In 1999, the Company established a 401(k) plan covering defined employees who meet established eligibility requirements. Under the original plan provisions, the company did not make matching

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tables are in thousands, except for share and per share data)

contributions. Effective September 15, 2000, the Company merged the plans of Touch 1 and Z-Tel and established a matching contribution for the 401(k) plan to 50% of participating contributions to a maximum matching amount of 5% of a participant's compensation. The Company contribution was approximately \$0.5 and \$0.2 million for the years ended December 31, 2001 and 2000, respectively.

17. STOCK-BASED COMPENSATION

Effective October 30, 1998, the Company adopted the 1998 Equity Participation Plan (1998 Plan), for the grant to eligible employees and eligible participants of options to purchase up to 1,261,000 shares of the Company's common stock. During September and November 1999, the Board of Directors (the Board) increased the shares available for grant under the 1998 Plan to 6.0 and 7.5 million shares, respectively.

Effective April 20, 2000, the Company adopted the 2000 Equity Participation Plan (2000 Plan), this plan allows for the grant to eligible employees and eligible participants of options to purchase up to 2.0 million shares of the Company's common stock. The 2000 Plan automatically increases the number of shares available for grant on the first day of the company's fiscal year beginning in 2001 equal to the lesser of (i) 3.0 million shares, (ii) 6% of the outstanding shares on such date, or (iii) a lesser amount determined by the Board.

The Plan is administered by a committee appointed by the Board, or by the Board. The Board or the appointed committee shall administer the 2000 Plan, select the eligible employees and eligible participants to whom options will be granted, the price to be paid, the exercise period and the number of shares subject to any such options and interpret, construe and implement the provisions of the 2000 Plan.

Stock option grants approximate the fair market value at the date of grant. The vesting periods on these options range from immediately to four years and have a maximum contractual life of ten years.

Prior to the adoption of the 1998 Plan, the Board awarded options (the Initial Plan) for the right to purchase 3,868,800 shares of common stock at a weighted average option price per share of \$2.83. The vesting periods on these options range from immediately to four years, and have a maximum contractual life of ten years.

A summary of the stock option activity for the years ended December 31, 2001, 2000 and 1999 is presented below:

	Initial Plan		1998 Equity Participation Plan		2000 Equity Participation Plan		Total	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Outstanding, December 31, 1998	3,799,300	\$ 2.83	201,050	\$ 3.64			4,000,350	\$ 2.88
Granted			3,181,225	5.78			3,181,225	5.78
Exercised	(305,094)	1.73	(1,466)	3.64			(306,560)	1.74
Forfeited	(155,873)	3.36	(202,945)	3.65			(358,818)	3.53
Outstanding, December 31, 1999	3,338,333	2.91	3,177,864	5.79			6,516,197	4.31
Granted			1,415,100	27.29	1,897,440	11.52	3,312,540	18.26
Exercised	(415,450)	2.47	(435,545)	4.15			(850,995)	3.33
Forfeited	(34,631)	2.67	(530,231)	14.71	(145,800)	12.34	(710,662)	13.64
Outstanding, December 31, 2000	2,888,252	2.98	3,627,188	13.07	1,751,640	11.45	8,267,080	9.20

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Granted					4,257,450	1.69	4,257,450	1.69
Exercised	(47,486)	2.32	(130,253)	3.64			(177,739)	3.29
Forfeited	(97,144)	2.49	(638,227)	12.70	(727,376)	9.84	(1,462,747)	10.60
Outstanding, December 31, 2001	2,743,622	\$ 3.01	2,858,708	\$ 13.58	5,281,714	\$ 3.81	10,884,044	\$ 6.17

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
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Had compensation cost for the Company's stock options granted been determined based on the fair value at the date of grant, consistent with the provisions of SFAS No. 123, the Company's net loss and loss per share of common stock for the years ended December 31, 2001, 2000 and 1999, respectively, would have been increased to the pro forma amounts shown below.

	Year Ended December 31,		
	2001	2000	1999
Net Loss			
As presented	\$(146,068)	\$(88,037)	\$(35,971)
As adjusted	(158,929)	(99,174)	(36,477)
Basic and Diluted Net Loss per Common Share			
As presented	\$ (5.03)	\$ (3.38)	\$ (2.49)
As adjusted	(5.41)	(3.72)	(2.53)

These adjusted amounts were determined using the Black-Scholes valuation model with the following key assumptions: (a) a discount rate of approximately 4.7%, 6.5%, and 5.7% for each of the years ended December 31, 2001, 2000, 1999, (b) a volatility factor of approximately 87%, 123% and 81% for each of the years ending December 31, 2001, 2000 and 1999, respectively; (c) an average expected option life of 5 years; (d) there have been no options that have expired; and (e) no payment of dividends on common stock.

During 2001, 2000 and 1999, respectively, included in the options granted by the Company, are 0, 0, and 695,082 options granted to non-employees. The Company recorded expense for the same periods, respectively, of approximately \$0.0, \$0.0, and \$0.3 million, respectively, related to these non-employee options in accordance with the provisions of SFAS No. 123.

The following table summarizes information about stock options outstanding at December 31, 2001:

Exercise Prices	Number Outstanding	Remaining Contractual Life (In Years)	Number Exercisable
\$0.82 - \$4.00	7,463,322	8.2	3,386,110
5.45 - 10.00	1,322,607	8.2	788,651
12.00 - 19.00	1,561,015	8.4	835,061
23.00 - 47.00	537,100	8.3	302,913
	10,884,044		5,312,735

18. COMPUTATION OF NET LOSS PER SHARE

Basic net loss per share is computed by dividing net loss attributable to common stockholders by the weighted average number of common shares outstanding during the period. Incremental shares of common stock equivalents are not included in the calculation of net loss per share as the inclusion of such equivalents would be anti-dilutive.

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
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Net loss per share is calculated as follows:

	Year Ended December 31,		
	2001	2000	1999
Basic and diluted net loss per share:			
Loss attributable to common stockholders:			
Net loss	\$ (146,068)	\$ (88,037)	\$ (35,971)
Less mandatorily redeemable convertible preferred stock dividends and accretion	(15,059)	(3,644)	(1,654)
Less deemed dividend related to beneficial conversion feature	(9,356)	(20,027)	
	\$ (170,483)	\$ (111,708)	\$ (37,625)
Weighted average common shares outstanding	33,908,374	33,066,538	15,099,359
Basic and diluted net loss per share	\$ (5.03)	\$ (3.38)	\$ (2.49)

For each of the periods presented, basic and diluted net loss per share are the same. Unexercised options to purchase 10,884,044, 8,267,080 and 6,516,197 shares of common stock, unexercised warrants to purchase 10,425,982, 4,602,457, and 637,332 shares of common stock, mandatorily redeemable convertible preferred stock convertible into 25,941,481, 9,174,605 and 0 shares of common stock for the years ended December 31, 2001, 2000 and 1999, respectively, which could potentially dilute basic earnings per share in the future. These potentially dilutive items were not included in the computation of diluted net loss per share for these periods because to do so would have been anti-dilutive in each case.

19. LEGAL AND REGULATORY PROCEEDINGS

On June 9, 2000, PTEK Holdings, Inc. and Premiere Communications, Inc. (collectively, "PTEK") filed a lawsuit against the Company, Z-Tel Communications, Inc., David Gregory Smith, Z-Tel's Chairman, Chief Executive Officer and President, Eduard Mayer, one of Z-Tel's directors and James Kitchen, a Senior Vice President of Z-Tel (the "Lawsuit").

On November 14, 2000, the parties to the Lawsuit agreed to resolve in full all claims asserted by each party against the other. In connection with the settlement, the Company agreed to issue a warrant to PTEK Holdings, Inc. to purchase 175,000 shares of the Company's common stock at an exercise price of \$12.00, which price is subject to certain adjustments. The warrant is fully vested and non-forfeitable but is not exercisable until two years after the issue date of the warrant. As a result of the issuance of the warrant and the accrual of legal fees related to the Lawsuit, the Company recognized an expense of approximately \$1.0 million for the year ended December 31, 2000.

On March 15, 2001, Z-Tel filed suit against AT&T. In that suit, Z-Tel alleged that AT&T had received originating and terminating access service from Z-Tel and has unlawfully withheld access charges for such services from Z-Tel. In July 2001, AT&T and the Company agreed to a settlement. In connection with that settlement, which approximated the amounts recorded by the Company as receivables, the Company resolved the issues relating to charges for access services rendered. The Company entered into a switched access agreement setting forth terms and conditions under which AT&T will purchase access services from the Company in the future.

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
(All tables are in thousands, except for share and per share data)

During June and July 2001, three separate class action lawsuits were filed against the Company, certain of the Company's current and former directors and officers (the "D&Os") and firms engaged in the underwriting (the "Underwriters") of our initial public offering of stock (the "IPO"). Each of the lawsuits is based on the allegations that the Company's registration statement on Form S-1, filed with the Securities and Exchange Commission ("SEC") in connection with the IPO, contained untrue statements of material fact and omitted to state facts necessary to make the statements made not misleading by failing to disclose that the underwriters had received additional, excessive and undisclosed commissions from, and had entered into unlawful tie-in and other arrangements with, certain customers to whom they allocated shares in the IPO. Plaintiffs have asserted claims against the Company and the D&Os pursuant to Sections 11 and 15 of the Securities Act of 1933 and Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated by the SEC thereunder. The plaintiffs seek an undisclosed amount of damages, as well as pre-judgment and post-judgment interest, costs and expenses, including attorneys' fees, experts' fees and other costs and disbursements. The lawsuits, along with all other lawsuits filed against other issuers arising out of IPO allocations, have been assigned to Judge Shira A. Scheindlin for pretrial coordination. The complaints have been consolidated into a single action, Case No. 01-5074. A consolidated complaint had not been filed or designated, and the Company is not required to file an answer or other responsive pleadings at this time.

In the ordinary course of business, the Company is involved in legal proceedings that are generally incidental to its operations. In addition, from time to time, the Company is the subject of customer complaints filed with the state utility commissions of the states in which it operates or the FCC. Most complaints are handled informally and at this time there are no formal proceedings pending. While there can be no assurance of the ultimate disposition of incidental legal proceedings or customer complaints, the Company does not believe their disposition will have a material adverse effect on the Company's consolidated results of operations or financial position.

20. SUBSEQUENT EVENTS

On January 28, 2002, the Company approved the extension of time to re-pay loans due December 31, 2001 until December 31, 2002. The loans are payable from three employees in the amounts of \$0.5, \$0.3, and \$0.1 million and will continue to accrue interest at 8% annually. These notes are collateralized by the shares of common stock acquired with the notes and the Company holds these shares in escrow.

On March 20, 2002, the Company entered into a four-year contract with MCI WORLDCOM Communications, Inc. ("MCI") whereby we expect to provide to MCI local exchange services, Z-Line Features, operational and support services and licenses to use certain of our proprietary technology, all for MCI's use in providing telecommunications services to residential and small business customers. The contract provides, among other things, that certain of our services will be provided at direct cost; we will receive technology licensing fees and fees for usage of our Z-Line platform, which provides the Z-Line Features; MCI will share with us gross profits it earns in providing certain Z-Line Features to its customers; MCI will purchase one million of our common shares; and Z-Tel will pay a cash signing bonus of \$2.3 million. The contract caps total software licensing fees at \$50 million, but until that cap is reached, monthly software licensing fees together with certain monthly per line fees for the use of our technology are not to be less than \$1.5 million, reduced by any prepayments made prior to the agreement. We expect to begin providing these services on a test basis in April 2002.

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Z-TEL TECHNOLOGIES, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
 (All tables are in thousands, except for share and per share data)

SUPPLEMENTAL QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

In the following summary of quarterly financial information, all adjustments necessary for a fair presentation of each period were included.

	Quarter Ended			
	March 31, 2000	June 30, 2000	September 30, 2000	December 31, 2000
Sales	\$ 13,976	\$ 40,157	\$ 54,415	\$ 69,120
Operating loss	(16,521)	(22,687)	(22,228)	(29,763)
Net loss	(15,476)	(23,055)	(23,109)	(26,397)
Loss per share (1)	\$ (0.48)	\$ (0.71)	\$ (0.96)	\$ (1.23)
Weighted average shares outstanding	31,941,964	33,042,008	33,536,724	33,717,824

	Quarter Ended			
	March 31, 2001	June 30, 2001	September 30, 2001	December 31, 2001
Sales	\$ 75,044	\$ 73,142	\$ 68,569	\$ 59,142
Operating loss	(19,630)	(107,878)	(12,213)	(9,420)
Net loss (2)(3)	(17,580)	(107,743)	(11,855)	(8,890)
Loss per share (1)	\$ (0.60)	\$ (3.27)	\$ (0.77)	\$ (0.40)
Weighted average shares outstanding	33,790,809	33,880,327	33,982,665	33,977,666

- (1) Earnings per share were calculated for each three month period on a stand-alone basis.
- (2) We recorded a \$59.2 million expense related to impaired assets in second quarter 2001.
- (3) We recorded a write-off of accounts receivable that resulted in \$29.9 million of additional bad debt expense in second quarter 2001.

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Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure*

None.

PART III

Item 10. *Directors and Executive Officers of the Registrant*

Directors and Executive Officers

Information regarding directors, nominees for director and executive officers is in our 2002 Annual Meeting proxy statement and is incorporated herein by reference.

Item 11. *Executive Compensation*

Information regarding executive compensation is included in the our 2002 Annual Meeting proxy statement and is incorporated herein by reference.

Item 12. *Security Ownership of Certain Beneficial Owners and Management*

Information required by this item is included in our 2002 Annual Meeting proxy statement and is incorporated herein by reference.

Item 13. *Certain Relationships and Related Transactions*

Information required by this item is included in our 2002 Annual Meeting proxy statement and is incorporated herein by reference.

PART IV

Item 14. *Exhibits, Financial Statement Schedules, and Reports on Form 8-K*

- (a) 1. The following financial statements of Z-Tel Technologies, Inc. and the report thereon of PricewaterhouseCoopers LLP dated February 22, 2002, except Note 20, as to which the date is March 20, 2001 are filed as part of this report:

Report of Independent Certified Public Accountants.

Consolidated Balance Sheets, December 31, 2001 and December 31, 2000

Consolidated Statements of Operations for the years ended December 31, 2001, 2000, 1999.

Consolidated Statements of Changes in Stockholders Equity (Deficit) for the years ended December 31, 2001, 2000, and 1999.

Consolidated Statements of Cash Flows for the years ended December 31, 2001, 2000 and 1999.

Notes to Financial Statements.

- (a) 2. The following Financial Statement Schedules are included herein:

Schedules are not submitted because they are not applicable or not required or because the required information is included in the financial statements or the notes thereto.

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- (a) 3. The following exhibits are filed as part of this report (exhibits marked with an asterisk have been previously filed with the Commission as indicated, and are incorporated herein by this reference):

EXHIBIT NUMBER	DESCRIPTION
2.1	Stock and Asset Purchase Agreement, dated June 30, 2001, by and among direcTEL Inc., a New Brunswick, Canada corporation, direcTEL, Inc., an Alabama corporation, Touch 1 Communications, Inc., an Alabama corporation, Z-Tel Technologies, Inc., a Delaware corporation and WebSmart Teleservices Group, Inc., a North Dakota corporation.
3.1	Amended and Restated Certificate of Incorporation of Z-Tel, as amended(A)*3.2
3.2	Amended and Restated Bylaws of Z-Tel(B)*4.1
4.1	Form of Common Stock Certificate(B)*4.2
4.2	See Exhibits 3.1 and 3.2 of this Form 10-K for provisions of the Amended and Restated Certificate of Incorporation, as amended, and the Bylaws of Z-Tel defining rights of security holders4.3
4.3	Stock Purchase Agreement, dated July 6, 2000, by and between the Registrant and the various purchasers of the Registrant s Series D Convertible Preferred Stock(C)*4.4
4.4	Certificate of Designations, Preferences and Relative Rights, Qualifications, Limitations and Restrictions relating to the Registrant s Series D Convertible Preferred Stock(C)*4.5
4.5	

Form of
Registration
Rights Agreement
by and between
the Registrant and
each of the
purchasers of the
Registrant s
Series D
Convertible
Preferred
Stock(C)*4.6
Form of Warrant
for the purchase
of shares of
common stock of
the Registrant by
each of the
purchasers of the
Registrant s
Series D
Convertible
Preferred
Stock(C)*4.7
Stock and
Warrant Purchase
Agreement, dated
October 19, 2000,
by and among the
Registrant and
The 1818 Fund
III, L.P.(D)*4.8
Certificate of
Designation of
8% Convertible
Preferred Stock,
Series E, Setting
Forth the Powers,
Preferences,
Rights,
Qualifications,
Limitations and
Restrictions of
Such Series of
Preferred Stock,
as
amended(A)*4.9
Registration
Rights Agreement
between and
among the
Registrant and
The 1818 Fund
III, L.P.(D)*4.10
Warrant for the
purchase of shares
of common stock
of the Registrant
by The 1818 Fund
III, L.P.(D)*4.11
Certificate of
Designation of

Series F Junior
Participating
Preferred
Stock(E)*4.12
Rights Agreement
dated as of
February 19, 2001
between Z-Tel
Technologies, Inc.
and American
Stock Transfer
Trust Company,
as Rights Agent,
as amended
July 2,
2001(E)*4.13
Stock and
Warrant Purchase
Agreement, dated
as of July 2, 2001,
by and between
Z-Tel, D. Gregory
Smith, and
others(G)4.14
Warrant for the
Purchase of
Shares of
Common Stock of
Z-Tel, dated as of
July 2,
2001(H)*4.15
Certificate of
Designation for
the Series G
Preferred
Stock(I)*4.16
Backup Purchase
Agreement, dated
as of July 2, 2001,
by and among
Z-Tel
Communications,
Inc., a Delaware
corporation and a
wholly owned
subsidiary of
Z-Tel, Touch 1
Communications,
Inc., an Alabama
corporation and a
wholly owned
subsidiary of
Z-Tel, D. Gregory
Smith and
others(J)*4.17
Additional
Investor
Registration
Rights
Agreement, dated
as of July 2, 2001,
between Z-Tel, D.

Gregory Smith
and
others(K)*4.18
Voting
Agreement, dated
as of June 29,
2001, between
Z-Tel and certain
stockholders of
Z-Tel(L)*4.19
Employee Stock
Restriction
Agreement, dated
September 1,
1999, by and
between the
Company and D.
Gregory
Smith(M)*

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EXHIBIT NUMBER	DESCRIPTION
10.1.1	Stockholders Agreement dated October 8, 1999, between and among the Company, BA Capital Corporation, Sewanee Partners II, L.P., Gramercy Z-Tel LLC and the other parties set forth therein(B)*
10.1.2	Employment Agreement dated July 1998 between the Company and D. Gregory Smith, as amended April 4, 2001 to increase his annual salary to \$275,000(B)*
10.1.4	Employment Agreement dated August 1998 between the Company and Charles W. McDonough as amended April 4, 2001 to increase his annual salary to \$240,000(B)*
10.1.5	Employment Agreement dated August 1998 between the Company and J. Bryan Bunting as amended April 4, 2001 to increase his annual salary to \$200,000(B)*
10.1.6	Employment Agreement dated July 1998 between the Company and James A. Kitchen as amended April 4, 2001 to increase his annual salary to \$175,000(B)*
10.1.7	Investment Agreement dated March 15, 1999 between the Company and CMB Capital LLC(B)*
10.2.1	1998 Equity Participation Plan(B)*
10.2.2	2000 Equity Participation Plan(N)*
10.4	Receivables Sales Agreement dated as of July 27, 2000 by and between Z-Tel Communications, Inc., as seller and subservicer, Touch 1 Communications, Inc., as

seller and subservicer,
and RFC Capital
Corporation, as
purchaser(C)*10.5 Form
of Indemnification
Agreement for executive
officers and directors of
the Company(E)*10.6
Loan and Guaranty
Agreement dated
January 11, 2001
between the Company
and James A.
Kitchen(E)*10.7
Secured Promissory Note
dated January 11, 2001
delivered by James A.
Kitchen to the
Company(E)*10.8
Pledge and Security
Agreement dated
January 11, 2001
between James A.
Kitchen and the
Company(E)*10.10
Promissory Note, dated
May 11, 1999, between
Touch 1
Communications, Inc.
and Corman Elegre
Capital(D)*10.11
Promissory Note, dated
September 10, 1999,
from Touch 1
Communications, Inc.
and William F. Corman
(First Revocable
Trust)(D)*10.12
Promissory Note, dated
September 10, 1999,
from Touch 1
Communications, Inc.
and
James F.
Corman(D)*21. List of
Subsidiaries23. Consent
of
PricewaterhouseCoopers
LLP

*

(A)
Incorporated by
reference to the
correspondingly
numbered
exhibit to the
Registrant s

Quarterly Report
on Form 10-Q
for the quarterly
period ended
June 30, 2001,
filed on
August 13,
2001.

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(B) Incorporated by reference to the correspondingly numbered exhibit to the Registrant's Registration Statement on Form S-1 (File No. 333-89063), originally filed October 14, 1999, as amended and as effective December 14, 1999.(C) Incorporated by reference to the correspondingly numbered exhibits to the Registrant's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2000, filed on August 14, 2000.(D) Incorporated by reference to the correspondingly numbered exhibits to the Registrant's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2000, filed on November 14, 2000.(E) Incorporated by reference to the correspondingly numbered exhibits to the Registrant's Annual Report on Form 10-K for the annual period ended December 31, 2000, filed on March 30,

2001.(F)

Incorporated by reference to the correspondingly numbered exhibits to the Registrant's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2001, filed on August 13,

2001.(G)

Incorporated by reference to Exhibit 1 to Amendment No. 1 of the Schedule 13D filed July 12, 2001 with respect to Z-Tel's common stock by, among other persons, The 1818 Fund III, L.P.(H)

Incorporated by reference to Exhibit 2 to Amendment No. 1 of the Schedule 13D filed July 12, 2001 with respect to Z-Tel's common stock by, among other persons, The 1818 Fund III, L.P.(I)

Incorporated by reference to Exhibit 3 to Amendment No. 1 of the Schedule 13D filed July 12, 2001 with respect to Z-Tel's common stock by, among other persons, The 1818 Fund III, L.P.(J)

Incorporated by reference to Exhibit 4 to Amendment No. 1 of the

Schedule 13D
filed July 12,
2001 with
respect to Z-Tel s
common stock
by, among other
persons, The
1818 Fund III,
L.P.(K)
Incorporated by
reference to
Exhibit 5 to the
Schedule 13D
filed July 24,
2001 with
respect to Z-Tel s
common stock
by, among other
persons, D.
Gregory
Smith.(L)
Incorporated by
reference to
Exhibit 5 to
Amendment
No. 1 of the
Schedule 13D
filed July 12,
2001 with
respect to Z-Tel s
common stock
by, among other
persons, The
1818 Fund III,
L.P.(M)
Incorporated by
reference to
Exhibit 7 to the
Schedule 13D
filed July 24,
2001 with
respect to Z-Tel s
common stock
by, among other
persons, D.
Gregory
Smith.(N)
Incorporated by
reference to
Appendix B to
the Registrant s
Preliminary
Proxy Statement
filed on April 14,
2000, with the
following
amendment
effective
May 31, 2001:

Section 2.1(a) of the Plan is hereby amended in its entirety to read as follows:

- (a) The shares of stock subject to Options, awards of Restricted Stock, Performance Awards, Dividend Equivalents, awards of Deferred Stock, Stock Payments or Stock Appreciation Rights shall be Common Stock, initially shares of the Company's Common Stock, par value \$0.01 per share. The aggregate number of such shares which may be issued upon exercise of such options or rights or upon any such awards under the Plan shall be Four Million Five Hundred Thousand (4,500,000) plus an annual increase to be added on the first day of the Company's fiscal year beginning in 2001 equal to the lesser of (i) Three Million (3,000,000) shares of the Company's Common Stock, (ii) 6% of the outstanding shares on such date, or (iii) a lesser amount determined by the Board. The shares of Common Stock issuable upon exercise of such options or rights or upon any such awards may be either previously authorized but unissued shares or treasury shares.

- (b) Reports on Form 8-K.
None.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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, as of the [26]th day of March, 2002.

Z-TEL TECHNOLOGIES, INC.

By: /s/ D. Gregory Smith

D. Gregory Smith, *President
and Chief Executive Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant in the capacities and on the dates indicated.

Signature	Title	Date
/s/ D. Gregory Smith _____	President, CEO, Chairman of the Board and Director (Principal Executive Officer)	March 26, 2002
D. Gregory Smith		
/s/ Horace J. Davis III _____	Senior Vice President Chief Financial Officer (Principal Financial and Accounting Officer)	March 26, 2002
Horace J. Davis III		
/s/ Charles W. McDonough _____	Senior Vice President Chief Technology Officer, and Director	March 26, 2002
Charles W. McDonough		
/s/ Jeffrey A. Bowden _____	Director	March 25, 2002
Jeffrey A. Bowden		
/s/ Charles D. Hyman _____	Director	March 26, 2002
Charles D. Hyman		
/s/ Andrew C. Cowen _____	Director	March 29, 2002
Andrew C. Cowen		

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/s/ John K. Aurrel Director March 26, 2002

John K. Aurrel

/s/ Mark S. Feighner Director March 26, 2002

Mark S. Feighner

/s/ Lawrence C. Tucker Director March 26, 2002

Lawrence C. Tucker