FREDS INC
Form 10-K
April 17, 2008

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K

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

For the Fiscal Year Ended February 2, 2008

Or

o **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 001-14565

FRED S, INC.

(Exact Name of Registrant as Specified in its Charter)

TENNESSEE	62-0634010
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification Number)

4300 New Getwell Road
MEMPHIS, TENNESSEE 38118
(Address of Principal Executive Offices)

Registrant s telephone number, including area code (901) 365-8880

Securities Registered Pursuant to Section 12(b) of the Act: None

Title of Class	**Name of exchange on which registered**
Class A Common Stock, no par value	The **NASDAQ** Global Select Market

Securities Registered Pursuant to Section 12(g) of the Act: None

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

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

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 þ No o

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 þ.

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. (Check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o Smaller reporting company o
(Do not check if a smaller reporting company)

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

Aggregate market value of the voting stock held by non-affiliates of the Registrant, based upon the last reported sale price on such date by the NASDAQ Stock Market, Inc. on August 3, 2007, the last business day of the registrant s most recently completed second fiscal quarter, was approximately $388 million. For the purposes of this disclosure only, the registrant has assumed that its directors, executive officers, and beneficial owners of greater than 10% of the registrant s common stock are the affiliates of the registrant.

As of April 11, 2008, there were 39,913,687 shares outstanding of the Registrant s Class A no par value voting common stock.

As of April 11, 2008, there were no shares outstanding of the Registrant s Class B no par value non-voting common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Company s Proxy Statement for the 2008 annual shareholders meeting, to be filed within 120 days of the registrant s fiscal year end, are incorporated herein by reference.

With the exception of those portions that are specifically incorporated herein by reference, the aforesaid documents are not to be deemed filed as part of this report.

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Cautionary Statement Regarding Forward-looking Information

Other than statements based on historical facts, many of the matters discussed in this Form 10-K relate to events which we expect or anticipate may occur in the future. Such statements are defined as forward-looking statements under the Private Securities Litigation Reform Act of 1995 (the Reform Act), 15 U.S.C.A. Sections 77z-2 and 78u-5 (Supp. 1996). The Reform Act created a safe harbor to protect companies from securities law liability in connection with forward-looking statements. Fred s Inc. (Fred s or the Company) intends to qualify both its written and oral forward-looking statements for protection under the Reform Act and any other similar safe harbor provisions.

The words believe , anticipate , project , plan , expect , estimate , objective , forecast , goal , intend , w continue and similar expressions generally identify forward-looking statements. All forward-looking statements are inherently uncertain, and concern matters that involve risks and other factors which may cause the actual performance of the Company to differ materially from the performance expressed or implied by these statements. Therefore, forward-looking statements should be evaluated in the context of these uncertainties and risks, including but not limited to:

- Economic and weather conditions which affect buying patterns of our customers and supply chain efficiency;
- Changes in consumer spending and our ability to anticipate buying patterns and implement appropriate inventory strategies;
- Continued availability of capital and financing;
- Competitive factors;
- Changes in reimbursement practices for pharmaceuticals;
- Governmental regulation;
- Increases in fuel and utility rates;
- Other factors affecting business beyond our control, including (but not limited to) those discussed under Part 1, ITEM 1A Risk Factors herein.

Consequently, all forward-looking statements are qualified by this cautionary statement. We undertake no obligation to update any forward-looking statement to reflect events or circumstances arising after the date on which it was made.

PART I

ITEM 1: Business

General

Fred s, founded in 1947, operates 692 (as of February 2, 2008) discount general merchandise stores in fifteen states primarily in the southeastern United States. Fred s stores generally serve low, middle and fixed income families located in small- to medium- sized towns (approximately 65% of Fred s stores are in markets with populations of 15,000 or fewer people). Full service pharmacies are included in 296 of the Company s stores (as of February 2, 2008). The Company also markets goods and services to 24 franchised Fred s stores. The Company is headquartered in Memphis, Tennessee.

Fred s stores stock over 12,000 frequently purchased items which address the everyday needs of its customers, including nationally recognized brand name products, proprietary Fred s label products and lower priced off-brand products. Fred s management believes its customers shop Fred s stores as a result of their convenient locations and consumer friendly sizes, consistent

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availability of products at everyday low prices and regularly advertised departmental promotions and seasonal specials. Fred s stores have average selling space of 15,239 square feet and had average sales of $2,625,000 in fiscal 2007. No single store accounted for more than 1.0% of net sales during fiscal 2007.

Business Strategy

The Company s strategy is to meet the general merchandise and pharmacy needs of the small- to medium- sized towns it serves by offering a wider variety of quality merchandise and a more attractive price-to-value relationship than either drug stores or smaller variety/dollar stores and a shopper-friendly format which is more convenient than larger sized discount merchandise stores. The major elements of this strategy include:

Wide variety of frequently purchased, basic merchandise Fred s combines everyday basic merchandise with certain specialty items to offer its customers a wide selection of over 12,000 frequently purchased items of general merchandise. The selection of merchandise is supplemented by seasonal specials, private label products, and the inclusion of pharmacies in many of its stores.

Discount prices The Company provides value and low prices to its customers (i.e., a good price-to-value relationship) through a coordinated discount strategy and an Everyday Low Pricing program that focuses on strong values daily, while minimizing the Company s reliance on promotional activities. As part of this strategy, Fred s maintains low opening price points and competitive prices on key products across all departments, and regularly offers seasonal specials and departmental promotions supported by direct mail, television, radio and newspaper advertising.

Convenient shopper-friendly environment Fred s stores are typically located in convenient shopping and/or residential areas. Approximately 37% of the Company s stores are freestanding as opposed to being located in strip shopping center sites. Freestanding sites allow for easier access and shorter distances to the store entrance. Fred s stores are of a manageable size and have an understandable store layout, and fast checkouts. By offering general merchandise and refrigerated foods together with pharmacies in many of its stores, we provide a full selection of merchandise to our customer.

Expansion Strategy The Company expects that expansion will occur primarily within its present geographic area and will be focused in small-to medium- sized towns. The Company may also enter larger metropolitan and urban markets where it already has a market presence in the surrounding area.

Fred s opened 35 stores and closed 20 stores in 2007. The majority of new stores opened in 2007 were located in Mississippi, Georgia, Texas, South Carolina and North Carolina. The Company s new store prototype has 16,000 square feet of space. Opening a new store currently costs between $450,000 and $575,000 for inventory, furniture, fixtures, equipment and leasehold improvements.

In 2007, the Company added 11 new pharmacies and closed 4 pharmacies. Approximately 43% of Fred s stores as of February 2, 2008 contain a pharmacy and sell prescription drugs. The Company s primary strategy for obtaining customers for new pharmacies is through the acquisition of prescription files from independent pharmacies. These acquisitions provide an immediate sales benefit, and in many cases, the independent pharmacist will move to Fred s, thereby providing continuity in the pharmacist-patient relationship.

In 2008, the Company plans to take a more conservative expansion approach and intends to open approximately 18 stores and 10 to 15 pharmacies. Additionally, the Company plans to increase the number of store closings when compared to historic patterns. A complete discussion of this strategic plan was released to the public on February 6, 2008 and is contained herein in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operation.

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The following tables set forth certain information with respect to stores and pharmacies for each of the last five fiscal years:

	2007	2006	2005	2004	2003
Stores open at beginning of period	677	621	563	488	414
Stores opened/acquired during period	35	59	65	81	79
Stores closed during period	(20)	(3)	(7)	(6)	(5)
Stores open at end of period	692	677	621	563	488
Number of stores with pharmacies at end of period	296	289	275	258	241
Square feet of selling space at end of period (in thousands)	10,215	9,946	9,091	8,270	7,134
Average square feet of selling space per store	15,239	15,290	15,269	15,267	15,166
Franchise stores at end of period	24	24	24	25	26

Fred s Xpress Designation: The term Xpress is given to a location that is intended to transition to a typical Fred s store. These locations range in size from 1,000 to 8,000 square feet, and enable the Company to enter a new market with an initial investment of under $400,000. These locations typically sell only pharmaceuticals and other health and beauty related items. Xpress locations usually originate from an acquisition and are in a location that is not suitable for the typical layout of a Fred s store. Therefore, the new store location is given the Xpress designation, and is marked for conversion to a typical Fred s store once a suitable location can be obtained. The Xpress designation is not a business strategy or a new line of business. It is simply a way of describing a small number of atypical stores in our chain that are awaiting conversion to a typical larger Fred s store layout. In all other ways, including resource allocation, management, training, marketing and corporate support, it is treated just as any other location in the chain. Given their smaller physical size, however, they are not stocked with the full breadth of merchandise in all departments that are carried by our other stores.

Within the population of Xpress locations, acquisitions are routinely being added and stores are being converted as suitable locations are found. At any given time the Company has approximately 25 stores that are designated as Xpress locations. Due to the small number of stores in transition relative to our total store population, Xpress stores represent a small portion of our sales and gross profit. Xpress sales, as a percentage of totals sales, for 2007, 2006, and 2005 were 2.7%, 3.1%, and 2.7%, respectively, and gross profit, as a percentage of total gross profit for the same time period was 2.4%, 2.3%, and 2.0%, respectively.

Merchandising and Marketing

The business in which the Company is engaged is highly competitive. The principal competitive factors include location of stores, price and quality of merchandise, in-stock consistency, merchandise assortment and presentation, and customer service. The Company competes for sales and store locations in varying degrees with national, regional and local retailing establishments, including department stores, discount stores, variety stores, dollar stores, discount clothing stores, drug stores, grocery stores, outlet stores, convenience stores, warehouse stores and other stores. Many of the largest retail merchandising companies in the nation have stores in areas in which the Company operates. Management believes that Fred s has a distinctive niche in that it offers a wider variety of merchandise at a more attractive price-to-value relationship than either a drug store or smaller variety/dollar store and is more shopper-convenient than a larger discount store. The variety and depth of merchandise

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offered in high traffic departments, such as health and beauty aids and paper and cleaning supplies, are comparable to those of larger discount retailers. Management believes that its knowledge of regional and local consumer preferences, developed over its 61 year history, enables the Company to compete very effectively in its region.

Purchasing

The Company s primary buying activities (other than prescription drug buying) are directed from the corporate office by the Executive Vice President and General Merchandise Manager through three Divisional Senior Vice Presidents of Merchandising who are supported by a staff of 22 buyers and assistants. The buyers and assistants are participants in an incentive compensation program, which is based upon various factors primarily relating to gross margin return on inventory. The Company purchases its merchandise from a wide variety of domestic and import suppliers. Many of the import suppliers generally require long lead times and orders are placed four to six months in advance of delivery. These products are either imported directly by us or acquired from distributors based in the United States and their purchase prices are denominated in United States dollars. The merchandising department manages all replenishment and forecasting functions with the Company s open-to-buy reports generated by proprietary software. The merchandising department develops vendor line reviews, assortment planning and the testing of new products and programs to continually improve overall inventory productivity and in-stock positions.

The Company purchased approximately 13% in 2007, 12% in 2006 and 11% in 2005 of the Company s warehouse purchases from Procter and Gamble. The Company believes that adequate alternative sources of products are available for these categories of merchandise.

During 2007, all of the Company s prescription drugs were ordered by its pharmacies individually and shipped direct from the Company s primary pharmaceutical wholesaler AmerisourceBergen Corporation (Bergen). Bergen provides substantially all of the Company s prescription drugs. During 2007, 2006, and 2005 approximately 36%, 37%, and 36%, respectively, of the Company s total purchases were made from Bergen. Although there are alternative wholesalers that supply pharmaceutical products, the Company operates under a purchase and supply contract with Bergen as its primary wholesaler. Accordingly, the unplanned loss of this particular supplier could have a short-term gross margin impact on the Company s business until an alternative wholesaler arrangement could be implemented. Excluding the purchases made from our pharmaceutical supplier and those made from Proctor and Gamble mentioned previously, no other supplier accounted for more than 3% of the Company s total purchases for the years 2007, 2006, and 2005.

Sales Mix

The Company s sales, which occur through Company owned stores and to franchised Fred s stores, constitute a single reportable operating segment.

The Company s sales mix by major category for the preceding three years was as follows:

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	For the Year Ended		
	February 2, 2008	February 3, 2007	January 28, 2006
Pharmaceuticals	32.2%	31.9%	31.3%
Household Goods	24.8%	24.7%	24.8%
Apparel and Linens	9.9%	11.7%	12.7%
Food and Tobacco Products	14.2%	13.0%	12.5%
Health and Beauty Aids	8.0%	8.0%	8.0%
Paper and Cleaning Supplies	8.8%	8.6%	8.5%
Sales to Franchised Fred s Stores	2.1%	2.1%	2.2%
Total Sales Mix	100.0%	100.0%	100.0%

The sales mix varies from store to store depending upon local consumer preferences and whether the stores include pharmacies and/or a full-line of apparel. In 2007, the average customer transaction size for comparable stores was approximately $18.75, and the number of customer transactions totaled approximately 88 million. The average transaction size was approximately $18.57 in 2006 and $17.91 in 2005.

Our private label program includes household cleaning supplies, health and beauty aids, disposable diapers, pet foods, paper products and a variety of beverage and other products. Private label products sold constituted approximately 3% of total sales for the years 2007, 2006, and 2005. Private label products afford the Company higher than average gross margins while providing the customer with lower priced products that are of a quality comparable to that of competing branded products. An independent laboratory-testing program is used for substantially all of the Company s private label products. As part of our 2008 strategic plan, we intend to expand our private label program. For a complete discussion, reference Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operation.

The Company sells merchandise to its 24 franchised Fred s stores. These sales during the last three years totaled approximately $37.3 million in 2007, $36.5 million in 2006, and $34.8 million in 2005. Franchise and other fees earned totaled approximately $2.0 million in 2007, $2.0 million in 2006, and $1.9 million in 2005. These fees represent a reimbursement for use of the Fred s name and administrative costs incurred on behalf of the franchised stores. The Company does not intend to expand its franchise network, and therefore, expects that this category will continue to decrease as a percentage of the Company s total revenues.

Advertising and Promotions

Net advertising and promotion costs represented approximately 1.5% of net sales in 2007 and 2006, and 1.4% in 2005. The Company uses direct mail, television, radio and 14 major newspaper-advertising circulars, one at the first of each month and two during the Christmas season. The Company utilizes 20 page full-color circulars coordinated by an internal advertising staff to promote its merchandise, special promotional events and a discount retail image. Additionally, the Company retains an outside advertising agency to assist with radio and television promotions, and to develop and implement the Company s branding strategy.

The Company s buyers have discretion to mark down slow moving items. The Company runs regular clearances of seasonal merchandise and conducts sales and promotions of particular items. The Company also encourages its store managers to create in-store advertising displays and signage in order to increase customer traffic and impulse purchases. Store managers have the flexibility to tailor the price structure at their particular store to meet competitive conditions within each store s marketing area.

Store Operations

All Fred s stores are open six days a week (Monday through Saturday), and most stores are open seven days a week (other than the pharmacy). Store hours are generally from 9:00 a.m. to 9:00 p.m.; however, certain stores are open only until 6:00 p.m. Each Fred s store is managed by a full-time store manager and those stores with a pharmacy employ a full-time pharmacist. The Company s 42 district managers and 5 Regional Vice Presidents supervise the management and operation of Fred s stores.

Fred s operates 296 pharmacies (as of February 2, 2008), which offer brand name and generic pharmaceuticals and are staffed by licensed pharmacists. The addition of acquired pharmacies in the Company s stores has resulted in increased store sales and sales per selling square foot. Management believes that the pharmacy department, in addition to the 41 other merchandise departments, increases customer traffic and repeat visits and is an integral part of the store s operation.

The Company has an incentive compensation plan for store managers, pharmacists and district managers based on meeting or exceeding targeted profit percentage contributions. Various factors included in determining profit percentage contribution are gross profits and controllable expenses at the store level. These factors of operating performance are reviewed regularly by executive management to pinpoint developments in key performance areas. Management believes that this incentive compensation plan, together with the Company s store management training program, are instrumental in maximizing store performance. The Company s training program covers all aspects of the Company s operation from product knowledge to handling customers with courtesy.

Inventory Control and Distribution

Inventory Control

The Company s centralized management information system maintains a daily stock-keeping unit (SKU) level inventory and current and historical sales information for each store and the distribution centers. This system is supported by our in-store point-of-sale (POS) system, which captures SKU and other data at the time of sale. The Merchandising arm of the system uses the data received from the stores to provide integrated inventory management, automated replenishment, promotional planning, space management, and merchandise planning. The Company conducts annual inventory counts at all Fred s stores and has implemented the use of radio frequency devices (RF guns) to conduct cycle counts to insure replenishment accuracy.

Distribution

The Company has an 850,000 square foot centralized distribution center in Memphis, Tennessee that services 370 stores and a 600,000 square foot distribution center in Dublin, Georgia that services 346 stores (see Properties below). Approximately 49% of the merchandise received by Fred s stores in 2007 was shipped through these distribution centers, with the remainder (primarily pharmaceuticals, certain snack food items, greeting cards, beverages and tobacco products) being shipped directly to the stores by suppliers. For distribution, the Company uses owned and leased trailers and tractors, as well as common carriers. The Company s Warehouse Management System is completely automated and provides conveyor control and pick, pack and ship processes by using portable radio-frequency terminals. This system is integrated with the Company s centralized management information system to provide up-to-date perpetual records as well as facilitating merchandise allocation and distribution decisions. The Company uses cycle counts through out the year to insure accuracy within the Warehouse Management System.

Seasonality

Our business is somewhat seasonal in that the Company s sales volume is heavier around the 1st of the calendar month. Many of the customers who shop at Fred s stores rely on government aid, social security, and other means that are typically paid at the 1st of the month. These governmental payment cycles coupled with the distribution of our newspaper-advertising circular are major factors in concentrating sales earlier in the calendar month. Generally, the highest volume of sales and net income occur in the fourth fiscal quarter, coincident with the

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holiday shopping season. The following table reflects the seasonality of net sales, gross profit, operating income, and net income by quarter. All of the quarters below are comprised of 13 weeks except for the 4th quarter of fiscal 2006 which is comprised of 14 weeks due to the 53 week year ending February 3, 2007.

For the year ended:	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
February 2, 2008				
Net sales	24.8%	23.8%	23.6%	27.8%
Gross profit	25.9%	24.8%	25.5%	23.8%
Operating profit (loss) *	67.8%	34.6%	43.7%	-46.1%
Net income (loss) *	69.4%	28.5%	43.0%	-40.9%
February 3, 2007				
Net sales	24.0%	23.4%	23.5%	29.1%
Gross profit	24.2%	23.3%	24.1%	28.4%
Operating profit	27.0%	15.2%	22.7%	35.1%
Net income	27.3%	16.1%	22.3%	34.3%
January 28, 2006				
Net sales	24.1%	23.5%	23.7%	28.7%
Gross profit	24.3%	23.4%	24.3%	28.0%
Operating profit	25.4%	13.7%	24.6%	36.3%
Net income	25.8%	13.3%	24.2%	36.7%

* Results for 2007 include certain charges for the planned closing of 75 stores (see Item 7 Exit and disposal activities section) and implementations of FIN 48.

Employees

At February 2, 2008, the Company had approximately 10,150 full-time and part-time employees, comprised of 1,020 corporate and distribution center employees and 9,130 store employees. The number of employees varies during the year, reaching a peak during the Christmas selling season, which typically begins after the Thanksgiving holiday. Only the Memphis, Tennessee distribution center employees are represented by the UNITE-HERE union pursuant to a three (3) year collective bargaining agreement which went into effect on July 1, 2005. The Company believes that it continues to have good relations with all of its employees.

Competition

The discount retail merchandise business is highly competitive. We compete in respect to price, store location, in-stock consistency, merchandise quality, assortment and presentation, and customer service with many other retailers, including mass merchandise, grocery, drug, convenience, variety and other specialty stores. Our competitors range from smaller, growing companies to considerably larger retail businesses that have greater financial, distribution, marketing and other resources than we do. There is no assurance that we will be able to compete successfully with them in the future. See Statement Regarding Forward-Looking Disclosures and Risk Factors .

GOVERNMENT REGULATION

As a publicly traded Company, we are subject to numerous federal securities laws and regulations, including the Securities Act of 1933 and the Securities Exchange Act of 1934 and related rules and regulations promulgated by the SEC, as well as the Sarbanes-Oxley Act of 2002. These laws and regulations impose significant

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requirements in the areas of accounting and financial reporting, corporate governance and insider trading, among others.

Each of our locations must comply with regulations adopted by federal and state agencies regarding licensing, health, sanitation, safety, fire and other regulations. In addition, we must comply with the Fair Labor Standards Act and various state laws governing various matters such as minimum wage, overtime and other working conditions. We must also comply with provisions of the Americans with Disabilities Act of 1990, as amended, which requires generally that employers provide reasonable accommodation for employees with disabilities and that our stores be accessible to customers with disabilities. The Company s pharmacy department, in particular, is subject to extensive federal and state laws and regulations.

Licensure and Regulation of Retail Pharmacies

There are extensive federal and state regulations applicable to the practice of pharmacy at the retail level. We are subject to numerous federal and state laws and regulations concerning the protection of confidential patient medical records and information, including the federal Health Insurance Portability and Accountability Act (HIPAA). Most states have laws and regulations governing the operation and licensing of pharmacies, and regulate standards of professional practice by pharmacy providers. These regulations are issued by an administrative body in each state, typically a pharmacy board, which is empowered to impose sanctions for non-compliance.

As a provider of Medicare prescription drug plan benefits, we are subject to various federal regulations promulgated by the Center for Medicare and Medicaid Services under the Medicare Prescription Drug, Improvement and Modernization Act of 2003. In the future we may also be subject to various state insurance laws and regulations in connection with the Company s pharmacy operations.

Future Healthcare Initiatives

Legislative and regulatory initiatives pertaining to such healthcare related issues as reimbursement policies, payment practices, therapeutic substitution programs, and other healthcare cost containment issues are frequently introduced at both the state and federal level. The Company is unable to predict accurately whether or when legislation may be enacted or regulations may be adopted relating to the Company s pharmacy operations or what the effect of such legislation or regulations may be.

Substantial Compliance

The Company s management believes the Company is in substantial compliance with all existing statutes and regulations material to the operation of the Company s businesses and is unaware of any material non-compliance action against the Company.

Environmental Matters

We are not aware of any federal, state or local environmental laws or regulations that will materially affect our earnings or competitive position, or result in material capital expenditures. However, we cannot predict the effect on our operations of possible future environmental legislation or regulations. During fiscal year 2007, we did not incur any material capital expenditures for environmental control facilities and no such material expenditures are anticipated.

Available Information

Our website address is http://www.fredsinc.com. We make available through this address, without charge, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to these reports as soon as reasonably practicable after these materials are electronically filed or furnished to the SEC.

ITEM 1A. RISK FACTORS

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Investors are encouraged to carefully consider the risks described below and other information contained in this document when considering an investment decision with respect to Fred s securities. Additional risks and uncertainties not presently known to management, or that management currently deems immaterial, may also impair the Company s business operations. Any of the events discussed in the risk factors below may occur. If one or more of these events do occur, business, results of operations or financial condition could be materially adversely affected. In that instance, the trading price of Fred s securities could decline, and investors might lose all or part of their investment.

The Company s business is somewhat seasonal.

The Company typically realizes a significant portion of its net sales and net income during the Christmas selling season in the fourth quarter. Our inventories and short-term borrowings increase in anticipation of this holiday season. A seasonal merchandise inventory imbalance could result if for any reason the Company s net sales during the Christmas selling season were to fall below seasonal norms. If for any reason our fourth quarter results were substantially below expectations, the Company s profitability and operating results could be adversely affected by unanticipated markdowns, especially in seasonal merchandise.

The Company operates in a competitive industry.

The Company is in a highly competitive sector of the discount retail merchandise business. This competitive environment subjects the Company to the risk of reduced profitability because of lower prices, and lower margins, required to maintain the Company s competitive position. The Company competes with discount stores and with many other retailers, including mass merchandise, grocery, drug, convenience, variety and other specialty stores, some of whom may have greater resources than the Company. This competitive environment subjects the Company to various risks, including the ability to continue to provide competitively priced merchandise to our customers that will allow the Company to maintain profitability and continue its store growth. Some of the Company s competitors utilize aggressive promotional activities, advertising programs, and pricing discounts and the Company s results of operations could be adversely affected if the Company does not respond effectively to these efforts.

Changes in third-party reimbursements, including government programs, could adversely affect our business.

A significant portion of the Company s sales is funded by federal and state governments and private insurance plans. For the years ended February 2, 2008 and February 3, 2007, approximately 32% of our sales were derived from pharmaceutical sales. The health care industry is experiencing a trend toward cost-containment with governments and private insurance plans seeking to impose lower reimbursements and utilization restrictions. Payments made under such programs may not remain at levels comparable to the present levels or be sufficient to cover our cost. Private insurance plans may base their reimbursement rates on the government rates. Accordingly, reimbursements may be limited or reduced, thereby adversely affecting our revenues and cash flows. Additionally, government or private insurance plans may adjust scheduled reimbursement payments to us in amounts that could have a material adverse effect on our cash flows and financial condition.

Changes in consumer demand and product mix; and changes in overall economic conditions could adversely affect our business.

Our success depends on our ability to anticipate and respond in a timely manner to changing customer demands and preferences for product mix. A general slowdown in the United States economy, rising personal debt levels, rising foreclosure rates, rising fuel prices, or changes in government aid, social security, and other means that many of our customers rely upon may adversely affect the spending of the Company s consumers, which would likely result in lower net sales than expected on a quarterly or annual basis. In addition, changes in the types of products available for sale and the selection of products by our customers affect sales, product mix and margins. Future economic conditions affecting disposable consumer income, such as employment levels, business conditions, fuel and energy costs, inflation, interest rates, and tax rates, could also adversely affect the Company s business by reducing consumer spending or causing consumers to shift their spending to other products. The Company might be unable to anticipate these buying patterns and implement

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appropriate inventory strategies, which would adversely affect its sales and gross profit performance. In addition, continued increases in fuel and energy costs would increase the Company s transportation costs and overall cost of doing business and could adversely affect the Company s financial statements as a whole.

Natural disasters or unusually adverse weather conditions could affect our business.

Unusually adverse weather conditions, natural disasters or similar disruptions, could significantly reduce the Company s net sales. In addition, these disruptions could also adversely affect the Company s supply chain efficiency and make it more difficult for the Company to obtain sufficient quantities of merchandise from its suppliers. A number of our stores are located in areas that are susceptible to hurricanes and tornados.

Merchandise supply and pricing and the interruption of and dependence on imports could adversely affect our business.

The Company has maintained good relations with its vendors and believes that it is generally able to obtain attractive pricing and other terms from vendors. We purchase a significant portion of our inventory from foreign suppliers, principally in the Far East. As a result, political instability or other events resulting in the disruption of trade from other countries or the imposition of additional regulations relating to or duties on imports could cause significant delays or interruptions in the supply of our merchandise or increase our costs. Also, our cost of these goods is affected by the fluctuation of the local currencies where these goods are produced against the dollar. Accordingly, changes in the value of the dollar relative to foreign currencies may increase our cost of goods sold and, if we are unable to pass such cost increases on to our customers, decrease our gross margins and ultimately our earnings. The Company purchases a significant amount of goods from Proctor and Gamble and several large import vendors and any disruption in that supply and or pricing of such merchandise could negatively impact the Company s operations and results.

Delays and costs of operating new stores and distribution facilities could have an adverse impact on our business.

The Company maintains two distribution facilities in its geographic territory, and plans on constructing new facilities as needed to support its growth. One of our key business strategies is to expand our base of retail stores. The Company plans on expanding and refreshing its network of stores through opening new stores and remodeling existing stores each year. Delays in opening stores or delays in opening distribution facilities to service those new stores could adversely affect the Company s future operations by slowing growth, which may in turn reduce revenue growth. Adverse changes in the cost to operate distribution facilities and stores, such as changes in labor, utilities, fuel and transportation, and other operating costs, could have an adverse impact on the Company.

Operational difficulties could disrupt our business.

The Company s stores are managed through a network of geographically dispersed management personnel. Inability of the Company to effectively and efficiently operate its stores, including the ability to control losses resulting from inventory shrinkage, may negatively impact the Company s sales and/or margin. In addition, the Company relies upon its distribution and logistics network to provide goods to stores in a timely and cost-effective manner; any disruption, unanticipated expense or operational failure related to this process could negatively impact store operations. The Company s operation depends on a variety of information technology systems for the efficient functioning of its business. The Company relies on certain software vendors to maintain and upgrade these systems as needed. The Company relies on telecommunications carriers to gather and disseminate its operations information. The disruption or failure of these systems or carriers could negatively impact the Company s operations.

Use of a single supplier of pharmaceutical products and our ability to negotiate satisfactory terms could adversely affect our business.

The Company has a long-term supply contract from a single supplier, AmerisourceBergen, for our pharmaceutical operations. Any significant disruption in our relationship with this supplier, deterioration in their financial condition, changes in terms, or an industry-wide change in wholesale business practices, including those of our supplier, could have a material adverse effect on the Company s operations.

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Higher costs and achievement of targeted results associated with the implementation of new programs, systems and technology could adversely affect our business.

The Company is undertaking a variety of operating initiatives as well as infrastructure initiatives. The failure to properly execute any of these initiatives could have an adverse impact on the future operating results of the Company.

Changes in state or federal legislation or regulations, including the effects of legislation and regulations on wage levels and entitlement programs; trade restrictions, tariffs, quotas and freight rates could adversely affect our business.

Unanticipated changes in federal or state wage requirements or other changes in workplace regulation could adversely impact the Company s ability to achieve its financial targets. Changes in trade restrictions, new tariffs and quotas, and higher shipping costs for goods could also adversely impact the ability of the Company to achieve anticipated operating results.

We depend on the success of new store opening program for Company growth and profitability.

The Company s growth is dependent on both increases in sales in existing stores and the ability to open new stores. Unavailability of store locations that the Company deems attractive, delays in the acquisition or opening of new stores, difficulties in staffing and operating new store locations and lack of customer acceptance of stores in expanded market areas all may negatively impact the Company s new store growth, the costs associated with new stores and/or the profitability of new stores.

Changes in the Company s ability to attract and retain employees, and changes in health care and other insurance costs could adversely affect our business.

The growth of the Company could be adversely impacted by its inability to attract and retain employees at the store operations level, in distribution facilities, and at the corporate level, including the Company s senior management team. Adverse changes in health care costs could also adversely impact the Company s ability to achieve its operational and financial goals and to offer attractive benefit programs to its employees.

Adverse impacts associated with legal proceedings and claims could affect our business.

The Company is party to a variety of legal proceedings and claims, including those described elsewhere in this Report. Operating results for the Company could be adversely impacted if legal proceedings and claims against the Company are made, requiring the payment of cash in connection with those proceedings or changes to the operation of the business.

Our ability to achieve the results of our strategic plan initiatives.

On February 6, 2008, the Company announced a strategic plan to improve profitability and operating margin by closing 75 under-performing stores, which is discussed in detail in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operation. The estimated costs and charges associated with these initiatives may vary materially and adversely based upon various factors, including the timing of execution, the outcome of negotiations with landlords and other third parties, or unexpected costs, any of which could result in our not realizing the anticipated benefits from the strategic plan.

Increases in our insurance-related costs could significantly affect our business.

The costs of many types of insurance and self-insurance, especially workers compensation, employee health care and others, have been increasing in recent years due to rising health care costs, legislative changes, economic conditions, terrorism and heightened scrutiny of insurance brokers and insurance providers. Our pharmacy departments are also exposed to risks inherent in the packaging and distribution of pharmaceuticals and other healthcare products, including with respect to improper filling of prescriptions, labeling of prescriptions and adequacy of warnings, and are significantly dependent upon suppliers to provide safe, government-approved and non-counterfeit products. We also sell a variety of products that we purchase from a large number of suppliers, including some who operate in foreign countries, which could become subject to contamination, product tampering, mislabeling or other damage. While we maintain reasonable quality assurance practices, no program can provide complete assurance that a product liability issue will not arise. Should a product liability issue arise, the coverage limits under our insurance programs may not be adequate to protect us against future claims. In addition, we may not be able to maintain this insurance on acceptable terms in the future. Damage to our reputation in the event of a product liability issue could have an adverse affect on our business. If our insurance-related costs increase significantly, or we are unable to renew our insurance policies or protect against all the business risks facing us, our financial position and results of operations could be adversely affected.

ITEM 1B: UNRESOLVED STAFF COMMENTS

None.

ITEM 2: Properties

As of February 2, 2008, the geographical distribution of the Company s 692 retail store locations in 15 states was as follows:

State	Number of Stores
Georgia	124
Mississippi	103
Tennessee	96
Alabama	90
Arkansas	69
South Carolina	55
Louisiana	43
North Carolina	34
Texas	27
Florida	22
Kentucky	10
Missouri	9
Illinois	7
Indiana	1
Oklahoma	2
Total stores:	692

The Company owns the real estate and the buildings for 67 locations (6 of which are closed), and owns the buildings at six locations which are subject to ground leases. The Company leases the remaining 631 locations from third parties pursuant to leases that provide for monthly rental payments primarily at fixed rates (although a number of leases provide for additional rent based on sales). Store locations range in size from 1,000 square feet to 27,000 square feet. Four hundred and thirty-nine of the locations are in strip centers or adjacent to a downtown-shopping district, with the remainder being freestanding.

It is anticipated that existing buildings and buildings to be developed by others will be available for lease to satisfy the Company s expansion program in the near term. It is management s intention to enter into leases of relatively moderate length with renewal options, rather than entering into long-term leases. The Company will thus have maximum relocation flexibility in the future, since continued availability of existing buildings is anticipated in the Company s market areas.

The Company owns its distribution center and corporate headquarters situated on approximately 60 acres in Memphis, Tennessee. The site contains the distribution center with approximately 850,000 square feet of space, and 250,000 square feet of office and retail space. Presently, the Company utilizes 90,000 square feet of office space and 22,000 square feet of retail space at the site. The retail space is operated as a Fred s store and is used to test new products, merchandising ideas and technology. The Company financed the construction of its 600,000 square foot distribution center in Dublin, Georgia with taxable industrial development revenue bonds issued by the City of Dublin and County of Laurens Development Authority. Presently, both distribution centers are able to serve a total of approximately 750 to 800 stores.

ITEM 3: Legal Proceedings

In June 2006, a lawsuit entitled Sarah Ziegler, et al. v. Fred s Discount Store was filed in the United States District Court for the Northern District of Alabama in which the plaintiff alleges that she and other current and former Fred s Discount assistant store managers were improperly classified as exempt executive employees under the Fair Labor Standards Act (FLSA) and seeks to recover overtime pay, liquidated damages, and attorneys fees and court cost. In July 2006, the plaintiffs filed an emergency motion to facilitate notice pursuant to the FLSA that would give current and former assistant manager s information about their rights to opt-in to the lawsuit. After initially denying the motion, in October 2006, the judge granted plaintiffs motion to facilitate notice pursuant to the FLSA. Notice was sent to some 2,055 current and former assistant store managers and approximately 450 persons opted into the case. The cut off date for individuals to advise of their interest in becoming part of this lawsuit was February 2, 2007.

The Company believes that its assistant store managers are and have been properly classified as exempt employees under the FLSA and that the actions described above are not appropriate for collective action treatment. The Company is and will continue to vigorously defend these actions in this matter. Discovery is ongoing and data continues to be reviewed. Following the close of the discovery period in this case, the Company will have an opportunity to seek decertification of the class, and the Company expects to file such a decertification and other motions.

In addition to the matter described above, the Company is party to other pending legal proceedings and claims arising in the normal course of business. Although the outcome of the proceedings and claims cannot be determined with certainty, management of the Company is of the opinion that it is unlikely that these proceedings and claims will have a material adverse effect on the financial statements as a whole. However, litigation involves an element of uncertainty. There can be no assurance that pending lawsuits will not consume the time and energies of our management or that future developments will not cause these actions or claims, individually or in aggregate, to have a material adverse effect on the financial statements as a whole. We intend to vigorously defend or prosecute each pending lawsuit.

ITEM 4: Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended February 2, 2008.

PART II

ITEM 5: Market for the Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The Company s common stock is traded on the NASDAQ Global Select Market under the symbol FRED. The following table sets forth the high and low sales prices, as reported in the regular quotation system of NASDAQ, together with cash dividends paid per share on the Company s common stock during each quarter in fiscal 2007 and fiscal 2006.

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Fiscal 2007	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
High	**$15.74**	**$15.00**	**$12.49**	**$11.07**
Low	**$13.12**	**$11.40**	**$ 9.71**	**$ 7.71**
Dividends	**$ 0.02**	**$ 0.02**	**$ 0.02**	**$ 0.02**

Fiscal 2006	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
High	**$16.40**	**$15.32**	**$15.00**	**$13.74**
Low	**$12.37**	**$12.75**	**$11.45**	**$11.30**
Dividends	**$ 0.02**	**$ 0.02**	**$ 0.02**	**$ 0.02**

The Company s stock price at the close of the market on April 11, 2008, was $9.88. There were approximately 21,000 shareholders of record of the Company s common stock as of April 11, 2008. The Board of Directors regularly reviews the Company s dividend plans to ensure that they are consistent with the Company s earnings performance, financial condition, need for capital and other relevant factors. The Company has paid cash dividends on its common stock since 1993.

Securities Authorized for Issuance under Equity Compensation Plans

Information for our equity compensation plans in effect as of February 2, 2008, is as follows:

Plan Category	Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column(a)) (c)
Equity compensation plans approved by security holders	1,216,451	$ 15.40	2,057,344
Equity compensation plans not approved by security holders	0	not applicable	0
Total	1,216,451	$ 15.40	2,057,344

Recent Sales of Unregistered Equity Securities and Use of Proceeds.

During the second and third quarter of fiscal 2007, we sold in a private placement an aggregate of 103,053 shares of our Class A common stock to Summit Properties, LLC (Summit) pursuant to the exemptions from registration provided in Section 4(2) of the Securities Act of 1933, as amended (the Act), and Rule 506 of Regulation D promulgated thereunder. The shares were issued in connection with our acquisition of the membership interests of

certain Limited Liability Companies and related real estate rights. The shares have subsequently been registered under the Act. We will not receive any proceeds from the resale of these shares.
The private placement that we made in reliance on the exemptions from registration under Section 4(2) of the Act and Rule 506 of Regulation D thereunder did not involve any public offering of common stock. In addition, Summit provided us with written representations that it was an accredited investor within the meaning of Rule 501(e) of Regulation D, that it was a sophisticated investor and that it had the knowledge and experience necessary to evaluate the risks and merits of the investment in our common stock. In addition, Summit was solicited on a private and

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confidential basis in a manner not involving any general solicitation or advertising in compliance with Regulation D.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers.

On August 27, 2007, the Board of Directors approved a plan that authorized stock repurchases of up to 4.0 million shares of the Company s common stock. Under the plan, the Company may repurchase its common stock in open market or privately negotiated transactions at such times and at such prices as determined to be in the Company s best interest. These purchases may be commenced or suspended without prior notice depending on then-existing business or market conditions and other factors. The following table sets forth the amounts of our common stock purchased by the Company during the fiscal year ended February 2, 2008(amounts in thousands, except price data). The repurchased shares have been cancelled and returned to authorized but un-issued shares.

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
August 27, 2007 September 10, 2007		$		4,000.0
September 11, 2007 October 3, 2007	190.1	$ 10.25	190.1	3,809.9
October 4, 2007 November 3, 2007	236.4	$ 10.24	236.4	3,573.5
November 4, 2007 February 2, 2008		$		3,573.5
Total	426.5	$ 10.25	426.5	

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ITEM 6: Selected Financial Data

Our selected financial data set forth below should be read in connection with Management s Discussion and Analysis of Financial Condition and Results of Operations (ITEM 7), Consolidated Financial Statements and Notes (ITEM 8), and the Forward-Looking Statement/Risk Factors disclosures (Item 1).

(dollars in thousands, except per share amounts)

	2007[6]	2006[3 & 5]	2005	2004	2003
Statement of Income Data:					
Net sales	$1,780,923	$1,767,239	$1,589,342	$1,441,781	$1,302,650
Operating income	16,457	40,949	40,081	39,426	49,100
Income before income taxes	15,664	40,213	39,255	38,633	48,702
Provision for income taxes	4,946	13,467	13,161	10,681	15,907
Net income	10,718	26,746	26,094	27,952	32,795
Net income per share:[1]					
Basic	.27	.67	.66	.71	.85
Diluted	.27	.67	.66	.71	.83
Cash dividend declared per share[1]	.08	.08	.08	.08	.08
Selected Operating Data:					
Operating income as a percentage of sales	0.9%	2.3%	2.5%	2.7%	3.8%
Increase in comparable store sales[2]	0.3%[7]	2.4%[4]	1.2%	2.2%	5.7%
Stores open at end of period	692	677	621	563	488
Balance Sheet Data (at period end):					
Total assets	$ 550,572	$ 515,709	$ 498,141	$ 465,224	$ 408,793
Short-term debt (including capital leases)	285	737	1,053	684	743
Long-term debt (including capital leases)	35,653	2,331	6,815	24,212	7,289
Shareholders equity	372,059	369,268	339,595	314,546	286,350

1 Adjusted for the 3-for-2 stock split effected on July 1, 2003.

2 A store is first included in the comparable store sales calculation after the end of the twelfth-month following the store s grand opening month. (See additional information regarding calculation of comparable store sales in Item 7 Results of Operations section.)

3 Results for 2006 include 53 weeks.

4 The increase in comparable store sales for 2006 is computed on the same 53-week period for 2005.

5 Results for 2006 include the implementation of FAS 123 (R).

6 Results for 2007 include certain charges for the planned closing of 75 stores, (see Item 7 Exit and disposal activities

section) and implementation of FIN 48.

7 The comparable store sales for 2007 is computed on a 52-week period.

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

General Accounting Periods

The following information contains references to years 2007, 2006, and 2005, which represent fiscal years ended February 2, 2008 (which was a 52-week accounting period), February 3, 2007 (which was a 53-week accounting period), and January 28, 2006 (which was a 52-week accounting period). This discussion and analysis should be read with, and is qualified in its entirety by, the Consolidated Financial Statements and the notes thereto. Additionally, our discussion and analysis should be read in conjunction with the Forward-Looking Statements/Risk Factors disclosures included herein.

Executive Summary

In 2007, we continued our strategy of refreshing and revitalizing our stores and capitalizing on our over 60 years of experience in the discount retail sector. Our Merchandise Refresher Program was completed during the third quarter of 2007. This program refreshed the look and feel of our stores with new paint and flooring, updated signage and the expansion and relocation of several departments. Additionally, our new branding and advertising campaign, which focuses on our over 60 year history while emphasizing the new look and feel of Fred s continued to be a key strategy as the year drew to a close. Two additional strategies that will be key to our success in 2008 continued to be focal points in the second half of 2007. The first involves an extensive market research program to determine customer preferences and expectations when visiting a Fred s store and the second involves a new site selection and real estate program to determine which locations best suit our customers. Another key element of our strategic plan that began to unfold in the latter part of 2007 was the introduction of new leadership, as well as an internal realignment of existing leadership. Continuing enhancements to or changes in our leadership team will also be focal points in 2008.

The integration of the aforementioned strategies coupled with our unique store layout allows us to offer our customers all the attractive elements of a discount dollar store, drug store and mass merchant under one roof. By offering elements of all three types of businesses, we are able to provide our customers with a ten minute Superstore experience in a smaller, easier and more convenient store layout.

The Company continued during the year to see paybacks on productivity improvements and key technology initiatives. Some of these include continuing enhancement of our point of sale and radio frequency (RF) store systems, refinement and upgrades to our merchandise planning and allocation systems and process and productivity standards improvements in our distribution centers.

As discussed in our Form 10-K for the fiscal year ended February 3, 2007, we slowed our new store growth during the year. This slow down in growth, coupled with the closing of unproductive stores, should have a positive impact on the Company s operating margin over time. In 2007, the Company opened 35 new stores and closed 20 stores. The majority of our new store openings were in Mississippi, Georgia, Texas and North and South Carolina. We did not enter into any new states during the year. Additionally, we opened eleven new pharmacies and closed four pharmacies throughout the course of the year.

During 2008, the Company will continue with its strategy of slowing growth and closing underperforming stores. Pursuant to this strategy, Fred s expects to open 18 new stores and 15 new pharmacies while closing 75 underperforming stores and 22 pharmacies. By closing underperforming locations, the Company intends to improve its cash flow and operating margin, both of which are core goals of the Company s overall strategic plan.

Also in 2008, we will focus on building our private label line of products which should build and solidify customer loyalty while simultaneously increasing gross margin. We are currently developing additional private label brand names that we believe the customer will find appealing and will become synonymous with Fred s promise to deliver quality products at low prices.

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Our Battleship Store Program which was developed late in 2007 will be operational in early 2008 and is intended to sharpen focus on our upper tier of profit producing stores. The intention of this program is to reward our customers with additional benefits such as expanded selections of products, one time or one of a kind type items, or special events such as treasure hunts or outdoor activities. Customer and employee appreciation are key tenants of the Battleship Program.

We will also continue in 2008 to focus on the 700 800 items we refer to as our We Got It items. These are consumable type items that we have promised, through our We Got It branding campaign, to always have on our shelves and available for our customers. We have implemented supply chain and distribution procedures to ensure that our We Got It pledge is fulfilled.

Over the course of 2008, we intend to continue with capital improvements in infrastructure, including new and existing store expansions and remodels, distribution center upgrades and further development of our information technology capabilities. Technology upgrades will be made in the areas of direct store delivery systems, stores POS systems, and pharmacy systems.

Key factors that will be critical to the Company s future success include managing the strategy for opening new stores and pharmacies, including the ability to open and operate efficiently, maintaining high standards of customer service, maximizing efficiencies in the supply chain, controlling working capital needs through improved inventory turnover, controlling the effects of inflation, especially in regard to occupancy costs, increasing operating margin through improved gross margin and leveraging operating costs, and generating adequate cash flow to fund the Company s expansion. Additionally, managing the store closing process effectively and efficiently will be a key factor in delivering projected benefits in 2008 and beyond.

Other factors that will affect Company performance in 2008 include the continuing management of the impacts of the changing regulatory environment in which our pharmacy department operates, especially the anticipated implementation of the federally approved change in pricing of generic pharmaceuticals to Average Manufacturer s Price (AMP), which could negatively affect gross margin. Additionally, inflated oil and gas prices continue to have a negative impact on our business in terms of reducing our customer s disposable income, as well as increasing the cost of our petroleum based products and increasing our transportation costs. We also believe that the current housing crisis is having an impact on the disposable income of our customers and will continue to do so well into 2008. Also, the Company will again experience an initial negative impact in selling, general and administrative expenses from the second year incremental raising of the Federal minimum wage; however, the increase should be a positive factor over time because it will directly impact the disposable income of our primary customer base. We also believe that the Economic Stimulus Package of 2008 and lower interest rates could be positive factors and may benefit our customers in the upcoming year.

Our business is subject to seasonal influences, but has tended to experience less seasonal fluctuation than many other retailers due to the mix of everyday basic merchandise and pharmacy business. Our fiscal fourth quarter is typically the most profitable quarter because it includes the Christmas selling season. The overall strength of the fourth quarter is partially mitigated, however, by the inclusion of the month of January, which is generally the least profitable month of the year.

Critical Accounting Policies

The preparation of Fred s financial statements requires management to make estimates and judgments in the reporting of assets, liabilities, revenues, expenses and related disclosures of contingent assets and liabilities. Our estimates are based on historical experience and on other assumptions that we believe are applicable under the circumstances, the results of which form the basis for making judgments about the values of assets and liabilities that are not readily apparent from other sources. While we believe that the historical experience and other factors considered provide a meaningful basis for the accounting policies applied in the Consolidated Financial

Statements, the Company cannot guarantee that the estimates and assumptions will be accurate under different conditions and/or assumptions. A summary of our critical accounting policies and related estimates and judgments, can be found in Note 1 to the Consolidated Financial Statements and the most critical accounting policies are as follows:

Revenue Recognition. The Company markets goods and services through Company owned stores and 24 franchised stores as of February 2, 2008. Net sales include sales of merchandise from Company owned stores, net of returns and exclusive of sales taxes. Sales to franchised stores are recorded when the merchandise is shipped from the Company s warehouse. Revenues resulting from layaway sales are recorded upon delivery of the merchandise to the customer. The Company also sells gift cards for which the revenue is recognized at time of redemption. The Company records a gift card liability on the date the gift card is issued to the customer. Revenue is recognized and the gift card liability is reduced as the customer redeems the gift card. The Company will recognize as revenue when the likelihood of the gift card being redeemed is remote (gift card breakage). The Company has not recognized any revenue from gift card breakage since the inception of the program in May 2004 and does not expect to record any gift card breakage revenue until there is more certainty regarding our ability to retain such amounts in light of current consumer protection and state escheatment laws.

In addition, the Company charges the franchised stores a fee based on a percentage of their purchases from the Company. These fees represent a reimbursement for use of the Fred s name and other administrative costs incurred on behalf of the franchised stores and are therefore netted against selling, general and administrative expenses. Total franchise income for 2007, 2006, and 2005 was $2,008, $2,019, and $1,891, respectively.

Inventories. Merchandise inventories are valued at the lower of cost or market using the retail first-in, first-out (FIFO) method for goods in our stores and the cost first-in, first-out (FIFO) method for goods in our distribution centers. The retail inventory method is a reverse mark-up, averaging method which has been widely used in the retail industry for many years. This method calculates a cost-to-retail ratio that is applied to the retail value of inventory to determine the cost value of inventory and the resulting cost of goods sold and gross margin. The assumption that the retail inventory method provides for valuation at lower of cost or market and the inherent uncertainties therein are discussed in the following paragraphs.

In order to assure valuation at the lower of cost or market, the retail value of our inventory is adjusted on a consistent basis to reflect current market conditions. These adjustments include increases to the retail value of inventory for initial markups to set the selling price of goods or additional markups to adjust pricing for inflation and decreases to the retail value of inventory for markdowns associated with promotional, seasonal or other declines in the market value. Because these adjustments are made on a consistent basis and are based on current prevailing market conditions, they approximate the carrying value of the inventory at net realizable value (market value). Therefore, after applying the cost to retail ratio, the cost value of our inventory is stated at the lower of cost or market as is prescribed by U.S. GAAP.

Because the approximation of net realizable value (market value) under the retail inventory method is based on estimates such as markups, markdowns and inventory losses (shrink), there exists an inherent uncertainty in the final determination of inventory cost and gross margin. In order to mitigate that uncertainty, the Company has a formal review by product class which considers such variables as current market trends, seasonality, weather patterns and age of merchandise to ensure that markdowns are taken currently, or a markdown reserve is established to cover future anticipated markdowns. This review also considers current pricing trends and inflation to ensure that markups are taken if necessary. The estimation of inventory losses (shrink) is a significant element in approximating the carrying value of inventory at net realizable value, and as such the following paragraph describes our estimation method as well as the steps we take to mitigate the risk that this estimate in the determination of the cost value of inventory.

The Company calculates inventory losses (shrink) based on actual inventory losses occurring as a result of physical inventory counts during each fiscal period and estimated inventory losses occurring between yearly physical inventory counts. The estimate for shrink occurring in the interim period between physical counts is calculated on a store-specific basis and is based on history, as well as performance on the most recent physical count. It is calculated by multiplying each store s shrink rate, which is based on the previously mentioned factors, by the interim period s sales for each store. Additionally, the overall estimate for shrink is adjusted at the corporate level to a three-year historical average to ensure that the overall shrink estimate is the most accurate approximation of shrink based on the Company s overall history of shrink. The three-year historical estimate is calculated by dividing the book to physical inventory adjustments for the trailing 36 months by the related sales for the same period. In order to reduce the uncertainty inherent in the shrink calculation, the Company first performs the calculation at the lowest practical level (by store) using the most current performance indicators. This ensures a more reliable number, as opposed to using a higher level aggregation or percentage method. The second portion of the calculation ensures that the extreme negative or positive performance of any particular store or group of stores does not skew the overall estimation of shrink. This portion of the calculation removes additional uncertainty by eliminating short-term peaks and valleys that could otherwise cause the underlying carrying cost of inventory to fluctuate unnecessarily. The Company has not experienced any significant change in shrink as a percentage of sales from year to year during the subject reporting periods.

Management believes that the Company s Retail Inventory Method provides an inventory valuation which reasonably approximates cost and results in carrying inventory at the lower of cost or market. For pharmacy inventories, which were approximately $31.1 million, and $36.4 million at February 2, 2008 and February 3, 2007, respectively, cost was determined using the retail LIFO (last-in, first-out) method in which inventory cost is maintained using the Retail Inventory Method, then adjusted by application of the Producer Price Index published by the U.S. Department of Labor for the cumulative annual periods. The current cost of inventories exceeded the LIFO cost by approximately $15.4 million at February 2, 2008 and $13.8 million at February 3, 2007. The LIFO reserve increased by approximately $1.6 million, $1.6 million, and $2.5 million, during 2007, 2006, and 2005, respectively.

The Company has historically included an estimate of inbound freight and certain general and administrative expenses in merchandise inventory as prescribed by Generally Accepted Accounting Principles. These costs include activities surrounding the procurement and storage of merchandise inventory such as buying, warehousing, and accounting, as well as inbound freight. During the second quarter which ended August 4, 2007, we revised our estimate to include certain costs internally captured within our Merchandise Planning, Information Technology and Human Resources departments as they relate to the inventory functions and support of procurement and storage. This revision follows growth in the role of these departments in support of the procurement and warehousing functions, including additional personnel hired over the past few quarters. Further, our Merchandise Planning department has evolved from being previously included within the buying function to a stand alone function with responsibility for inbound logistics and commodity procurement. The total amount of expenses and inbound freight included in merchandise inventory at February 2, 2008 is $21.9 million, with the corresponding amount of $19.8 million at February 3, 2007.

Impairment. The Company s policy is to review the carrying value of all long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. In accordance with Statement of Financial Accounting Standards (SFAS) 144, Accounting for the Impairment or Disposal of Long-Lived Assets, we review for impairment all stores open or remodeled more than two years. Impairment results when the carrying value of the assets exceeds the undiscounted future cash flows over the life of the lease. Our estimate of undiscounted future cash flows over the lease term is based upon historical operations of the stores and estimates of future store profitability which encompasses many factors that are subject to management s judgment and are difficult to predict. If a long-lived asset is found to be impaired, the amount recognized for impairment is equal to the difference between the carrying value and the asset s fair value. The

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fair value is based on estimated market values for similar assets or other reasonable estimates of fair market value based upon management s judgment.

Exit and disposal activities. During the year ended February 2, 2008, the Company recorded a below-cost inventory adjustment of approximately $10.0 million in cost of goods sold to value inventory at the lower of cost or market and a charge of $4.6 million in selling, general and administrative expense for the impairment of fixed assets and leasehold improvements associated with the planned closure of 75 stores in the upcoming fiscal year. The planned closures will take place during the first three quarters of the upcoming year and are the result of an in-depth study conducted by the Company of its operations over the last 10 quarters. The study revealed that Fred s has a strong and healthy store base, and that by closing these 75 underperforming stores the Company will improve it s cash flow and operating margin, both of which are core goals of the Company s overall strategic plan. With the successful execution of this plan, the Company will become stronger and will be in a better position to respond to fluctuations in the economy and take advantage of opportunities to further improve our business.

Also during the year ended February 2, 2008, the Company utilized the $0.9 million reserve that was taken as a below-cost inventory adjustment and charged to cost of goods sold in the year ended February 3, 2007 for store closures that took place during the current year.

In addition, the Company completed its exit from the boys and girls apparel lines and as such utilized the reserve of $1.2 million that was taken as a below-cost inventory adjustment and charged to cost of goods sold in the year ended February 3, 2007.

The following table summarizes the current year balances and activity of the liabilities associated with the aforementioned exit and disposal activities:

(in millions)	Beginning Balance February 3, 2007	Utilized during 2007	Reversal for stores not closed during 2007	Additional Reserves Added 2007	Ending Balance February 2, 2008
Inventory markdowns for discontinuance of boys & girls apparel	$1.2	$ 1.2	$	$	$
Inventory markdowns for planned store closings	0.9	0.8	0.1	10.0	10.0
Lease contract termination costs	0.1	1.1		1.6	0.6
	$2.2	$ 3.1	$ 0.1	$ 11.6	$ 10.6

For store closures where a lease obligation still exists, we record the estimated future liability associated with the rental obligation on the cease use date (when the store is closed) in accordance with SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities. Liabilities are established at the cease use date for the present value of any remaining operating lease obligations, net of estimated sublease income, and at the communication date for severance and other exit costs, as prescribed by SFAS 146. Key assumptions in calculating the liability include the timeframe expected to terminate lease agreements, estimates related to the sublease potential of closed locations, and estimation of other related exit costs. If actual timing and potential termination costs or realization of sublease income differ from our estimates, the resulting liabilities could vary from recorded amounts. These liabilities are reviewed periodically and adjusted when necessary.

Associated with the store closings in the current year, the Company incurred $1.6 million in lease contract termination cost, which was charged to rent expense, and expects to incur $10.8 million in lease contract termination costs in association with the stores that are planned to be closed in the upcoming year.

Property and equipment and intangibles. Property and equipment are carried at cost. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets and recorded in selling, general and administrative expenses. Improvements to leased premises are depreciated using the straight-line method over the shorter of the initial term of the lease or the useful life of the improvement. Leasehold improvements added late in the lease term are depreciated over the shorter of the remaining term of the lease (including the upcoming renewal option, if the renewal is reasonably assured) or the useful life of the improvement, whichever is lesser. Gains or losses on the sale of assets are recorded at disposal as a component of operating income. The following average estimated useful lives are generally applied:

	Estimated Useful Lives
Building and building improvements	8 - 30 years
Furniture, fixtures and equipment	3 - 10 years
Leasehold improvements	3 - 10 years or term of lease, if shorter
Automobiles and vehicles	3 - 5 years
Airplane	9 years

Assets under capital leases are depreciated in accordance with the Company s normal depreciation policy for owned assets or over the lease term (regardless of renewal options), if shorter, and the charge to earnings is included in depreciation expense in the Consolidated Financial Statements.

Other identifiable intangible assets, which are included in other noncurrent assets, primarily represent customer lists associated with acquired pharmacies and are being amortized on a straight-line basis over five years.

Vendor rebates and Allowances. The Company receives rebates for a variety of merchandising activities, such as volume commitment rebates, relief for temporary and permanent price reductions, cooperative advertising programs, and for the introduction of new products in our stores. In accordance with the Emerging Issues Task Force Issue No. 02-16, Accounting by a Customer (including a Reseller) for Certain Consideration Received from a Vendor (EITF 02-16), rebates received from a vendor are recorded as a reduction of cost of sales when the product is sold or a reduction to selling, general and administrative expenses if the reimbursement represents a specific incremental and identifiable cost. Should the allowance received exceed the incremental cost, then the excess is recorded as a reduction of cost of sales when the product is sold. Any excess amounts for the periods reported are immaterial. Any rebates received subsequent to merchandise being sold are recorded as a reduction to cost of goods sold when received.

As of February 2, 2008, the Company had approximately 750 vendors who participate in vendor rebate programs and the terms of the agreements with those vendors vary in length from short-term arrangements to be completed within three months to longer-term arrangements that could last up to three years.

In accordance with The American Institute of Certified Public Accountants Statement of Position No. 93-7, Reporting on Advertising Costs (AICPA SOP 93-7), the Company charges advertising, including production costs, to selling, general and administrative expense on the first day of the advertising period. Gross advertising expenses for 2007, 2006, and 2005, were $27.6 million, $27.4 million, and $22.3 million, respectively. Gross advertising expenses were reduced by vendor cooperative advertising allowances of $1.5 million, $1.1 million, and $.5 million, for 2007, 2006, and 2005, respectively. It would be the Company s intention to incur a similar amount of advertising expense as in prior years and in support of our stores even if we did not receive support from our vendors in the form of cooperative adverting programs.

Insurance reserves. The Company is largely self-insured for workers compensation, general liability and employee medical insurance. The Company s liability for self-insurance is determined based on claims known at the time of determination of the reserve and estimates for future payments against incurred losses and claims that have been incurred but not reported. Estimates for future claims costs include uncertainty because of the variability of the factors involved, such as the type of injury or claim, required services by the providers, healing time, age of claimant, case management costs, location of the claimant, and governmental regulations. These uncertainties or a deviation in future claims trends from recent historical patterns could result in the Company recording additional expenses or expense reductions that might be material to the Company s results of operations. The Company carries additional coverage for excessive or catastrophic claims with stop loss limits of $250,000 for property and general liability and $200,000 for employee medical. The Company s insurance reserve was $8.2 million and $8.6 million on February 2, 2008 and February 3, 2007, respectively. Changes in the reserve over that time period were attributable to additional reserve requirements of $38.3 million netted with reserve utilization of $38.7 million.

Income Taxes. In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No.109. We adopted FIN 48 as of February 4, 2007, the first day of fiscal 2007. This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109 and prescribes a minimum recognition threshold of more-likely-than-not to be sustained upon examination that a tax position must meet before being recognized in the financial statements. Under FIN 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, FIN 48 provides guidance on de-recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition.

As a result of the adoption of FIN 48, we recognized a cumulative effect adjustment of $4.2 million decrease to beginning retained earnings and a reclassification of certain amounts between deferred income taxes ($2.3 million decrease) and other non-current liabilities ($6.5 million increase, including $1.0 million of interest and penalties) to conform to the balance sheet presentation requirements of FIN 48. The Company increased the gross reserve for uncertain tax positions from $6.5 million to $7.3 million, a change of $0.8 million to disclose the gross liability rather than reflect the liability net of federal income tax benefit.

A reconciliation of the beginning and ending amount of the unrecognized tax benefits is as follows:

(in millions)		
Balance at February 4, 2007	$	7.3
Additions for tax position related to current year		1.5
Additions for tax position of prior years		.4
Reductions for tax position of prior years		(.8)
Settlements		
Balance at February 2, 2008	$	8.4

As of February 4, 2007, our liability for unrecognized tax benefits totaled $7.3 million, of which $0.5 million and $0.3 million were recognized as income tax benefit during the periods ending November 3, 2007 and February 2, 2008, respectively, as a result of a lapse in applicable statute of limitations. As of February 2, 2008, our liability for unrecognized tax benefits totaled $8.4 million and is recorded in our consolidated balance sheet with Other Liabilities, all of which, if recognized, would affect our effective tax rate.

FIN 48 further requires that interest required to be paid by the tax law on the underpayment of taxes should be accrued on the difference between the amount claimed or expected to be claimed on the tax return and the tax benefit recognized in the financial statements. The Company includes potential interest and penalties recognized in accordance with FIN 48 in the financial statements as a component of income tax expense. As of February 2, 2008, accrued interest and penalties related to

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our unrecognized tax benefits totaled $ 1.0 million and $ 0.4 million, respectively, and are both recorded in the consolidated balance sheet within Other non-current liabilities.

Stock-based compensation. Effective January 29, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), Share-Based Payment , using the modified prospective transition method. Under this method, compensation expense recognized post adoption includes: (1) compensation expense for all share-based payments granted prior to, but not yet vested as of, January 29, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (2) compensation cost for all share-based payments granted subsequent to January 29, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). Results for prior periods have not been restated.

In November 2005, FASB issued Staff Position No. FAS 123(R)-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards (FSP FAS 123R-3). Effective January 29, 2006, the Company elected to adopt the alternative transition method provided in FSP FAS 123R-3 for calculating the income tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in-capital pool (APIC Pool) related to the income tax effects of stock based compensation, and for determining the subsequent impact on the APIC pool and consolidated statements of cash flows of the income tax effects of stock-based compensation awards that are outstanding upon adoption of SFAS 123(R).

SFAS 123(R) also requires the benefits of income tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required prior to SFAS 123(R). The impact of adopting SFAS 123(R) on future results will depend on, among other things, levels of share-based payments granted in the future, actual forfeiture rates and the timing of option exercises.

Prior to January 28, 2006, the Company accounted for share-based payments using the intrinsic-value-based recognition method prescribed by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25). As stock options were granted at an exercise price equal to the market value of the underlying common stock on the date of grant, no stock option compensation expense was reflected in net income prior to adopting SFAS 123(R).

Stock-based compensation expense, post adoption of SFAS 123(R), is based on awards ultimately expected to vest, and therefore has been reduced for estimated forfeitures. Forfeitures are estimated at the time of grant based on the Company s historical forfeiture experience and will be revised in subsequent periods if actual forfeitures differ from those estimates. For periods prior to 2006, the Company in its proforma disclosures under SFAS 123, recognized forfeitures as they occurred.

The following represents total stock based compensation expense (a component of selling, general and administrative expenses) recognized in the consolidated financial statements *(in thousands)*:

	2007	**2006**
Stock option expense	$ 1,312	$ 1,408
Restricted stock expense	591	512
ESPP expense	213	279
Total stock-based compensation	2,116	2,199
Income tax benefit on stock-based compensation	$ 340	$ 210

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As a result of adopting SFAS 123(R), the Company s income before income taxes and net income for fiscal year 2006, were $1.7 million and $1.7 million lower, respectively, than if it had continued to account for share-based compensation under APB 25. Basic and diluted earnings per share for fiscal year 2006 were $.04 and $.04 lower respectively, than if the Company had continued to account for share-based compensation under APB 25.

The Company uses the Modified Black-Scholes Option Valuation Model (BSM) to measure the fair value of stock options granted to employees. The BSM option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock volatility and option life. Because the Company s employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

The fair value of each option granted is estimated on the date of grant using the BSM with the following weighted average assumptions:

	2007	2006	(Pro Forma) 2005
Stock Options			
Expected volatility	42.8%	41.4%	46.6%
Risk-free interest rate	4.1%	4.8%	4.3%
Expected option life (in years)	5.8	5.9	5.3
Expected dividend yield	0.4%	0.4%	0.5%
Weighted average fair value at grant date	$4.68	$6.01	$7.35
Employee Stock Purchase Plan			
Expected volatility	37.2%	38.7%	41.4%
Risk-free interest rate	4.7%	4.8%	4.3%
Expected option life (in years)	0.63	0.63	0.5
Expected dividend yield	0.38%	0.3%	0.2%
Weighted average fair value at grant date	$3.31	$4.31	$3.37

The following is a summary of the methodology applied to develop each assumption:

Expected Volatility This is a measure of the amount by which a price has fluctuated or is expected to fluctuate. The Company uses actual historical changes in the market value of our stock to calculate expected price volatility because management believes that this is the best indicator of future volatility. The Company calculates weekly market value changes from the date of grant over a past period representative of the expected life of the options to determine volatility. An increase in the expected volatility will increase compensation expense.

Risk-free Interest Rate This is the yield of a U.S. Treasury zero-coupon bond issue effective at the grant date with a remaining term equal to the expected life of the option. An increase in the risk-free interest rate will increase compensation expense.

Expected Lives This is the period of time over which the options granted are expected to remain outstanding and is based on historical experience. Options granted have a maximum term of seven and one-half years. An increase in the expected life will increase compensation expense.

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Dividend Yield   This is based on the historical yield for a period equivalent to the expected life of the option. An increase in the dividend yield will decrease compensation expense.
Forfeiture Rate   This is the estimated percentage of options granted that are expected to be forfeited or cancelled before becoming fully vested. This estimate is based on historical experience. An increase in the forfeiture rate will decrease compensation expense.
Equity Incentive Plans. See Note 7 to the Consolidated Financial Statements for additional information regarding equity incentive plans.

Results of Operations

The following table provides a comparison of Fred s financial results for the past three years. In this table, categories of income and expense are expressed as a percentage of sales.

	For the Year Ended		
	February 2, 2008(3)	**February 3, 2007(3)**	**January 28, 2006**
Net Sales	100.0%	100.0%	100.0%
Cost of goods sold (1)	72.5	72.0	71.8
Gross profit	27.5	28.0	28.2
Selling, general and administrative expenses (2)	26.6	25.7	25.7
Operating income	0.9	2.3	2.5
interest expense, net	0.0	0.0	0.1
Income before taxes	0.9	2.3	2.4
Income taxes	0.3	0.8	0.8
Net income	0.6%	1.5%	1.6%

(1) Cost of goods sold includes the cost of the product sold, along with all costs associated with inbound freight.

(2) Selling, general and administrative expenses include the costs associated with purchasing, receiving, handling, securing, and

storing product. These costs are associated with products that have been sold and no longer remain in ending inventory.

(3) Results for the year ended February 2, 2008 and February 3, 2007, include certain charges for the planned closing of 75 stores in 2008 and the 20 stores closed in 2007(See Item 7, Exit and Disposal Activities section).

Comparable Sales: Our policy regarding the calculation of comparable store sales represents the increase or decrease in net sales for stores that have been opened after the end of the twelfth-month following the store s grand opening month, including stores that have been remodeled or relocated during the reporting period. The majority of our remodels and relocations do not include expansion. The purpose of the remodel or the relocation is to change the store s layout, refresh the store with new fixtures, interiors or signage or to locate the store in a more desirable area. This type of change to the store does not necessarily change the product mix or product departments; therefore, on a comparable store sales basis, the store is the same before and after the remodel or relocation. In relation to remodels and relocations, expansions have been much more infrequent and consequently, any increase in the selling square footage is immaterial to the overall calculation of comparable store sales.

Additionally, we do not exclude newly added hardline, softline or pharmacy departments from our comparable store sales calculation because we believe that all departments

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within a Fred s store create a synergy supporting our overall goals for managing the store, servicing our customer and promoting traffic and sales growth. Therefore, the introduction of all new departments is included in same store sales in the year in which the department is introduced. Likewise, our same store sales calculation is not adjusted for the removal of a department from a location.

Fiscal 2007 Compared to Fiscal 2006

Sales

Net sales increased 0.8% ($13.7 million) in 2007. Approximately $8.4 million of the increase was attributable to a net addition of 15 new stores, and a net addition of 7 pharmacies during 2007, together with the sales of 56 store locations and 14 pharmacies that were opened or upgraded during 2006 and contributed a full year of sales in 2007. During 2007, the Company closed 20 stores and 4 pharmacy locations. Comparable store sales, consisting of sales from stores that have been open for more than one year, increased 0.3% in 2007, which accounted for $ 5.3 million in sales. Comparable store sales for 2007 are computed excluding the effect of the extra week in 2006 due to the 53-week period.

The Company s 2007 front store (non-pharmacy) sales increased approximately 0.3% over 2006 front store sales. Excluding week 53 sales the front store sales increased approximately 2.9% over 2006 front store sales. Front store sales growth benefited from the above mentioned store additions and improvements, and sales increases in certain categories such as food, beverages, paper and chemicals, tobacco, greeting cards, prepaid products, electronics, hardware, and pets.

Fred s pharmacy sales were 32.2% of total sales in 2007 and 31.9% of total sales in 2006 and continue to rank as the largest sales category within the Company. The total sales in this department, including the Company s mail order operation, increased 1.6% over 2006, with third party prescription sales representing approximately 92% of total pharmacy sales, the same as in the prior year. The Company s pharmacy sales growth continued to benefit from an ongoing program of purchasing prescription files from independent pharmacies and the addition of pharmacy departments in existing store locations.

Sales to Fred s 24 franchised locations increased approximately $0.8 million in 2007 and represented 2.1% of the Company s total sales, the same as in 2006. The increase in sales to franchised locations results primarily from the sales volume increases experienced by the franchise locations during the year. It is anticipated that this category of business will continue to decline as a percentage of total Company sales since the Company has not added and does not intend to add any additional franchisees.

Gross Margin

Gross margin as a percentage of sales decreased to 27.5% in 2007 compared to 28.0% in 2006. The decrease in gross margin results primarily from the $10.0 million below-cost inventory adjustment associated with the planned closure of 75 under performing stores in 2008. An improvement in the pharmacy department s gross margin due to a greater percentage of generic dispensing offset lower general merchandise margins in 2007.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were $445.2 million (25.0% of net sales) in 2007 compared to $424.9 million (24.0% of net sales) in 2006. The increase as a percent of net sales was from the recording of $4.6 million for asset impairments for the planned closure of 75 under performing stores (0.3%), increased payroll cost of $5.1 million (0.2%), increased property rents of $4.4 million (0.2%), higher utilities of $2.4 million (0.1%), and increased legal and professional cost of $2.2 million (0.1%). Depreciation and amortization expense

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was $28.6 million (1.6% of net sales) in 2007 compared to $29.1 million (1.6 % of net sales) for 2006.

Operating Income

Operating income decreased to $16.5 million in 2007 from $40.9 million in 2006. Operating income as a percentage of sales was 0.9% in 2007 down from 2.3% in 2006, due primarily to the above-mentioned decrease in gross margin and increase in selling, general and administrative expenses.

Interest Expense, Net

Net interest expense for 2007 totaled $.8 million or less than .1% of sales compared to $.7 million which was also less than .1% of sales in 2006.

Income Taxes

The effective income tax rate was 31.6% in 2007 compared to 33.5% in 2006, primarily as a result of various jobs tax credits.

The Company s estimates of income taxes and the significant items resulting in the recognition of deferred tax assets and liabilities are described in Note 4 to the Consolidated Financial Statements and reflect the Company s assessment of future tax consequences of transactions that have been reflected in the Company s financial statements or tax returns for each taxing authority in which it operates. Actual income taxes to be paid could vary from these estimates due to future changes in income tax law or the outcome of audits completed by federal and state taxing authorities. The reserves are determined based upon the Company s judgment of the probable outcome of the tax contingencies and are adjusted, from time to time, based upon changing facts and circumstances.

State net operating loss carry-forwards are available to reduce state income taxes in future years. These carry-forwards total approximately $122.2 million for state income tax purposes and expire at various times during 2008 through 2027. If certain substantial changes in the Company s ownership should occur, there would be an annual limitation on the amount of carry-forwards that can be utilized. We have provided a reserve for the portion believed to be more likely than not to expire unused.

We expect our effective tax rate to increase in fiscal 2008 to 35% 36% from fiscal 2007 and fiscal 2006 levels due to the expiration of federal credits for jobs in the 2005 hurricane impact zone and the mid year end expiration of state tax incentives offered by Georgia.

Net Income

Net income for 2007 was $10.7 million (or $.27 per diluted share) compared to $26.7 million (or $.67 per diluted share) reported in 2006.

Fiscal 2006 Compared to Fiscal 2005

Sales

Net sales increased 11.2% ($177.9 million) in 2006. Approximately $139.8 million of the increase was attributable to a net addition of 56 new stores, and a net addition of 14 pharmacies during 2006, together with the sales of 58 store locations and 17 pharmacies that were opened or upgraded during 2005 and contributed a full year of sales in 2006. During 2006, the Company closed 3 stores and 2 pharmacy locations. Comparable store sales, consisting of sales from stores that have been open for more than one year, increased 2.4% in 2006, which accounted for $ 38.1 million in sales. Comparable store sales for 2006 are computed on the same 53-week period for 2005.

The Company s front store (non-pharmacy) sales increased approximately 10.4% over 2005 front store sales. Front store sales growth benefited from the above mentioned store additions and improvements, and sales increases in certain categories such as food, beverages, paper and chemicals, tobacco, greeting cards, prepaid products, electronics, hardware, and pets.

Fred s pharmacy sales were 31.9% of total sales in 2006 and 31.3% of total sales in 2005 and continue to rank as the largest sales category within the Company. The total sales in this department, including the Company s mail order operation, increased 13.5% over 2005, with third party prescription sales representing approximately 92% of total pharmacy sales, an increase from 88% in the prior year. The Company s pharmacy sales growth continued to benefit from an ongoing program of purchasing prescription files from independent pharmacies and the addition of pharmacy departments in existing store locations.

Sales to Fred s 24 franchised locations increased approximately $1.7 million in 2006 and represented 2.1% of the Company s total sales, as compared to 2.2% in 2005. The increase in sales to franchised locations results primarily from the sales volume increases experienced by the franchise locations during the year. It is anticipated that this category of business will continue to decline as a percentage of total Company sales since the Company has not added and does not intend to add any additional franchisees.

Gross Margin

Gross margin as a percentage of sales decreased to 28.0% in 2006 compared to 28.2% in 2005. The decrease in gross margin results primarily from the $1.2 million below-cost inventory adjustment associated with the discontinuance of the boys and girls apparel departments, as well as the $.9 million below-cost inventory adjustment for planned store closings. Additionally, the increase in lower margin on Medicare sales in the Company s pharmacy department led to the decline in overall Company gross margin.

Selling, General and Administrative Expenses

Selling, general and administrative expenses were $424.9 million (24.0% of net sales) in 2006 compared to $380.4 million (23.9% of net sales) in 2005. The increase as a percent of net sales was from higher fuel costs affecting distribution costs (0.1%), higher utilities (0.1%), increased advertising (0.1%) offset by decreases as a percent to net sales in payroll (0.1%) and insurance (0.1%). Depreciation and amortization expense was $29.1 million (1.6% of net sales) in 2006 compared to $27.8 million (1.7 % of net sales) for 2005.

Operating Income

Operating income increased $.8 million or 2.0% to $40.9 million in 2006 from $40.1 million in 2005. Operating income as a percentage of sales was 2.3% in 2006 down from 2.5% in 2005, due primarily to the above-mentioned decrease in gross margin.

Interest Expense, Net

Net interest expense for 2006 totaled $.7 million or less than .1% of sales compared to $.8 million or .1% of sales in 2005.

Income Taxes

The effective income tax rate was 33.5% in 2006, the same rate as in 2005.

State net operating loss carry-forwards are available to reduce state income taxes in future years. These carry-forwards total approximately $116.3 million for state income tax purposes and expire at various times during the period 2007 through 2026. If certain substantial changes in the Company s ownership should occur, there would be an annual limitation on the amount of carry-forwards that can be utilized. We have provided a reserve for the portion believed to be more likely than not to expire unused.

The Company s estimates of income taxes and the significant items resulting in the

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recognition of deferred tax assets and liabilities are described in Note 4 to the Consolidated Financial Statements and reflect the Company s assessment of future tax consequences of transactions that have been reflected in the Company s financial statements or tax returns for each taxing authority in which it operates. Actual income taxes to be paid could vary from these estimates due to future changes in income tax law or the outcome of audits completed by federal and state taxing authorities. We maintain income tax contingency reserves for potential assessments from the federal government or other taxing authority. The reserves are determined based upon the Company s judgment of the probable outcome of the tax contingencies and are adjusted, from time to time, based upon changing facts and circumstances. Changes to the tax contingency reserve could materially affect the Company s future consolidated operating results in the period of change.

Net Income

Net income for 2006 was $26.7 million (or $.67 per diluted share) or approximately 2.5% higher than the $26.1 million (or $.66 per diluted share) reported in 2005.

Liquidity and Capital Resources

The Company s principal capital requirements include funding new stores and pharmacies, remodeling existing stores and pharmacies, maintenance of stores and distribution centers, and the ongoing investment in information systems. Fred s primary sources of working capital have traditionally been cash flow from operations and borrowings under its credit facility. The Company had working capital of $270.5 million, $239.9 million, and $214.0 million at year-end 2007, 2006, and 2005, respectively. Working capital fluctuates in relation to profitability, seasonal inventory levels, net of trade accounts payable, and the level of store openings and closings. Working capital at year-end 2007 increased by approximately $30.6 million from 2006. The increase was primarily attributed to an increase in cash and cash equivalents and inventory, supported by increased long-term borrowings. The Company plans to open 11 new stores and 3 new pharmacies during the first quarter of 2008.

During 2005, 2006 and 2007, we incurred losses caused by fire and tornado damage, which consisted primarily of losses of inventory and fixed assets. We reached settlements on some of our insurance claims related to inventory and fixed assets in 2006 and 2007. Insurance proceeds related to fixed assets are included in cash flows from investing activities and proceeds related to inventory losses and business interruption are included in cash flows from operating activities.

Net cash flow provided by operating activities totaled $19.3 million in 2007, $35.3 million in 2006, and $48.5 million in 2005.

In fiscal 2007, inventory, net of the LIFO reserve, increased by approximately $25.3 million due to improving in-stock positions in the basic and consumable product categories as well as slower sales than projected during the 2007 Holiday season. This increase was offset by a $10.0 million non-cash reduction in inventory resulting from the below-cost inventory adjustment related to the planned store closures in the upcoming year. Accounts receivable increased by approximately $8.1 million due an increase in income tax receivable which reflects overpayment of estimated taxes due to lower than anticipated sales.

In fiscal 2006, inventory, net of the LIFO reserve, increased by approximately $2.1 million due to controlling inventory and improving merchandise quality during the fiscal year. Accounts receivable increased by approximately $17.5 million due primarily to the shift in our year ending date to include the higher volume of activity around the 1st of the month, combined with increased vendor rebates not yet collected.

In fiscal 2005, cash was primarily used to increase inventories by approximately $30.9 million, or 10%, during the fiscal year. This increase is primarily attributable to our adding a net of 58 new stores, upgrading 12 stores and adding a net of 17 new pharmacies, as well as supporting the increase in comparable store sales. Accounts payable and accrued expenses increased by $12.7 million due primarily to increase in inventory and higher accrued payroll expenses. Income taxes payable increased by approximately $6.2 million due to the increase in the effective tax rate and no estimated payments made in 2005. Capital expenditures in 2007 totaled $31.4 million compared to $26.5 million in 2006 and $27.8 million in 2005. The capital expenditures during 2007 consisted primarily of the store and pharmacy expansion program ($15.3 million), acquisition of previously leased land and buildings ($11.7 million), expenditures related to the Store Refresher Program ($7.5 million) and technology and other corporate expenditures ($4.2 million). The Company also assumed debt of $6.1 million and issued $1.2 million in common stock for the acquisition of store real estate. The 2006 capital expenditures included approximately $11.9 million for new stores and pharmacies, $11.7 million for upgrading existing stores and $2.9 million for technology, corporate and other capital expenditures. The 2005 capital expenditures included approximately $18.3 million for new stores and pharmacies, $7.1 million for upgrading existing stores and $2.4 million for technology, corporate and other capital expenditures. Cash used for investing activities also includes $1.7 million in 2007, $3.4 million in 2006, and $3.2 million in 2005 for the acquisition of prescription lists and other pharmacy related items and $1.1 million in 2007 and $0.3 million in 2006 from insurance proceeds related to fixed assets reimbursements.

In 2008, the Company is planning capital expenditures totaling approximately $18.3 million. Expenditures are planned totaling $11.3 million for new and existing stores and pharmacies. Planned expenditures also include approximately $1.0 million for technology upgrades, and approximately $4.0 million for distribution center equipment and capital maintenance. Technology upgrades in 2008 will be made in the areas of direct store delivery systems, stores POS systems, and pharmacy systems. In addition the Company plans expenditures of approximately $2.0 million in 2008 for the acquisition of prescription lists and other pharmacy related items.

Cash and cash equivalents were $10.3 million at the end of 2007 compared to $2.5 million at the end of 2006 and $3.1 million at the end of 2005. Short-term investment objectives are to maximize yields while minimizing company risk and maintaining liquidity. Accordingly, limitations are placed on the amounts and types of investments the Company can select.

On August 27, 2007, the Board of Directors approved a plan that authorized stock repurchases of up to 4.0 million shares of the Company s common stock. Under the plan, the Company may repurchase its common stock in open market or privately negotiated transactions at such times and at such prices as determined to be in the Company s best interest. These purchases may be commenced or suspended without prior notice depending on then-existing business or market conditions and other factors. In fiscal 2007 the Company repurchased 426,500 shares for $4.4 million.

On October 30, 2007, the Company and Regions Bank entered into an amendment of their Revolving Loan and Credit Agreement (agreement) to provide an increase in the credit line from $50 million to $75 million and to extend the term until July 31, 2009. All other terms, conditions and covenants remained in place after the amendment. Borrowings under the Agreement bear interest at 1.5% below the prime rate or a LIBOR-based rate. Under the most restrictive covenants of the Agreement, the Company is required to maintain specified shareholders equity (which was $292.3 million at February 2, 2008) and net income levels. The Company is required to pay a commitment fee to the bank at a rate per annum equal to 0.15% on the unutilized portion of the revolving line commitment over the term of the Agreement. There were $30.6 million and $2.2 million of borrowings outstanding under the Agreement at February 2, 2008 and February 3, 2007, respectively. The increase in debt was due to an increase in inventory to improve in-stock positions and capital expenditures to acquire the land and building occupied by thirteen Fred s stores that we had previously leased. The weighted average interest rate on borrowings under Agreement was 5.76% and 5.93% at February 2, 2008 and February 3, 2007, respectively.

On October 10, 2005, the Company and Regions Bank, successor in interest to Union Planters, entered into a Seventh Modification Agreement of the Revolving Loan and Credit Agreement to provide a temporary increase of commitment of $20 million and increasing the available credit line to $70 million. The term of the agreement was from October 10, 2005 until December 15, 2005. On December 15, 2005, the available credit line reverted to $50 million. All terms, conditions and covenants remained in place for the Note and credit facility.

On July 29, 2005 the Company and Regions Bank, successor in interest to Union Planters, entered into a Sixth Modification Agreement of the Revolving Loan and Credit Agreement (the Agreement) dated April 3, 2000 to increase the commitment from the bank from $40 million to $50 million and to extend the term until July 31, 2009. The Agreement bears interest at 1.5% below the prime rate or a LIBOR-based rate. All terms, conditions and covenants remained in place for the Note and credit facility.

The Company believes that sufficient capital resources are available in both the short-term and long-term through currently available cash, cash generated from future operations and, if necessary, the ability to obtain additional financing.

Off-Balance Sheet Arrangements

The Company has no off-balance sheet financing arrangements.

Effects of Inflation and Changing Prices. The Company believes that inflation and/or deflation had a minimal impact on its overall operations during fiscal years 2007, 2006 and 2005.

Contractual Obligations and Commercial Commitments

As discussed in Note 5 to the Consolidated Financial Statements, the Company leases certain of its store locations under noncancelable operating leases expiring at various dates through 2029. Many of these leases contain renewal options and require the Company to pay contingent rent based upon percent of sales, taxes, maintenance, insurance and certain other operating expenses applicable to the leased properties. In addition, the Company leases various equipment under noncancelable operating leases and certain transportation equipment under capital leases.

The following table summarizes the Company s significant contractual obligations as of February 2, 2008, which excludes the effect of imputed interest:

(Dollars in thousands)		**Payments due by period**			
Contractual Obligations	**Total**	**< 1 yr**	**1-3 yrs**	**3-5 yrs**	**>5 yrs**
Capital Lease obligations (1)	$ 129	$ 129			
Revolving loan (2)	31,860		31,860		
Operating leases (3)	195,275	47,523	72,021	44,582	31,149
Equipment leases (4)	8,081	1,988	3,963	2,070	60
Inventory purchase obligations (5)	137,043	137,043			
Postretirement benefits (6)	539	40	88	94	317
Mortgage Loans on land & buildings(7)	5,177	164	839	328	3,846
Total Contractual Obligations	$378,104	$186,887	$108,771	$47,074	$35,372

* On February 2, 2008, a liability for unrecognized tax benefits for $8.352 million has been excluded from this table as the timing of payment cannot

be reasonably estimated.

(1) Capital lease obligations include related interest.

(2) Revolving loan represents principle maturity for the Company s revolving credit agreement and includes estimated interest of $1.225 million on $30.635 million of debt at 4.0% for 1 year.

(3) Operating leases are described in Note 5 to the Consolidated Financial Statements.

(4) Equipment leases representing cooler program and other equipment operating leases.

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(5) Inventory purchase obligations represent open purchase orders and any outstanding purchase commitments as of February 2, 2008.

(6) Postretirement benefits are described in Note 9 to the Consolidated Financial Statements.

(7) Mortgage loans for purchased land and buildings.

As discussed in Note 9 to the Consolidated Financial Statements, the Company had commitments approximating $14.3 million at February 2, 2008 on issued letters of credit, which support purchase orders for merchandise. Additionally, the Company had outstanding letters of credit aggregating $17.1 million at February 2, 2008 utilized as collateral for their risk management programs.

The Company financed the construction of its Dublin, Georgia distribution center with taxable industrial development revenue bonds issued by the City of Dublin and County of Laurens development authority. The Company purchased 100% of the bonds and intends to hold them to maturity, effectively financing the construction with internal cash flow. The Company has offset the investment in the bonds ($34.6 million) against the related liability and neither is reflected in the consolidated balance sheet.

Related Party Transactions

During the year ended February 2, 2008, Atlantic Retail Investors, LLC, which is partially owned by Michael J. Hayes, a director and officer of the Company, purchased the land and buildings occupied by thirteen Fred s stores. The stores were purchased by Atlantic Retail Investors, LLC from an independent landlord/developer. Prior to the purchase by Atlantic Retail Investors, LLC the Company was offered the right to purchase the same stores and declined the offer. The terms and conditions regarding the leases on these locations are consistent in all material respects with other stores leases of the Company. The total rental payments related to these leases was $.585 million for the year ended February 2, 2008. Total future commitments under related party leases are $7.078 million.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements . SFAS No. 157 provides a single definition of fair value, together with a framework for measuring it, and requires additional disclosure about the use of fair value to measure assets and liabilities. SFAS No. 157 also emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. Under SFAS No. 157, fair value measurements are required to be disclosed by level within that hierarchy. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal

years. However, FASB Staff Position (FSP) No. FAS 157-2, Effective Date of FASB Statement No. 157, issued in February 2008, delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis, to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The Company is in the process of determining the effect, if any, that the adoption of SFAS No. 157 will have on its results of operations or financial position.
In February 2007, the Financial Accounting Standards Board issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 , (SFAS No. 159). SFAS No. 159 allows companies the choice to measure many financial instruments and certain other items at fair value. This gives a company the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently reviewing the impact of SFAS No. 159, if any, on our Consolidated Financial Statements and expect to complete this evaluation in 2008.
In March 2007, the Emerging Issues Task Force (EITF) reached a consensus on issue number 06-10, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements, (EITF 06-10). EITF 06-10 provides guidance to help companies determine whether a liability for the postretirement benefit associated with a collateral assignment split-dollar life insurance arrangement should be recorded in accordance with either SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions (if, in

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substance, a postretirement benefit plan exists), or Accounting Principles Board Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract). EITF 06-10 also provides guidance on how a company should recognize and measure the asset in a collateral assignment split-dollar life insurance contract. EITF 06-10 is effective for fiscal years beginning after December 15, 2007, although early adoption is permitted. The Company has evaluated EITF 06-10 and has determined that it will have no impact on its results of operations or financial position.
In May 2007, the FASB issued FASB Staff Position No. FIN 48-1, Definition of Settlement in FASB Interpretation No. 48 (FSP
FIN 48-1). FSP FIN 48-1 amends FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, to provide guidance on how an enterprise should determine whether a tax position is effectively settled for the purposes of recognizing previously unrecognized tax benefits. The Company adopted FIN 48-1 as of February 4, 2007 and is now required to apply the guidance provided in FSP FIN 48-1. The application of FSP FIN 48-1 has not had a material effect on the Company s financial position, results of operations, or cash flows.
In June 2007, the Emerging Issues Task Force (EITF) of the FASB ratified their consensus position 06-11 (EITF 06-11), Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards. EITF 06-11 provides guidance on how a company should recognize the income tax benefit received on dividends that are paid to employees holding equity-classified nonvested shares, equity-classified nonvested share units, or equity-classified outstanding share options charged to retained earnings under FASB Statement 123(R), Share-Based Payment. The Company is required to apply the guidance provided in EITF 06-11 prospectively to income tax benefits of dividends on equity-classified employee share-based payment awards that are declared in fiscal years beginning after September 15, 2007. Early application of EITF 06-11 is permitted for the income tax benefit of dividends on equity-classified employee share-based payment awards that are declared in periods for which financial statements have not yet been issued. The Company is in the process of determining the effect, if any, that the adoption of EITF 06-11 will have on its results of operations or financial position.
In December 2007, the FASB issued FASB Statement No. 141 (R), Business Combinations (FAS 141(R)), which establishes accounting principles and disclosure requirements for all transactions in which a company obtains control over another business. Statement 141 (R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is in the process of determining the effect, if any, that the adoption of FAS 141 (R) will have on its results of operations or financial position.
In December 2007, the FASB issued FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements An Amendment of ARB No. 51. Statement 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Statement 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is in the process of determining the effect, if any, that the adoption of FASB No. 160 will have on its results of operations or financial position.

ITEM 7a: Quantitative and Qualitative Disclosure about Market Risk

The Company has no holdings of derivative financial or commodity instruments as of February 2, 2008. The Company is exposed to financial market risks, including changes in interest rates. All borrowings under the Company s Revolving Credit Agreement bear interest at 1.5% below prime rate or a LIBOR-based rate. An increase in interest rates of 100 basis points would not significantly affect the Company s income. All of the Company s business is transacted in U.S. dollars and, accordingly, foreign exchange rate fluctuations have never had a significant impact on the Company, and they are not expected to in the foreseeable future.

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ITEM 8: Financial Statements and Supplementary Data

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Fred s Inc.
Memphis, Tennessee

We have audited the accompanying consolidated balance sheets of Fred s Inc., as of February 2, 2008 and February 3, 2007 and the related consolidated statements of income and comprehensive income, changes in stockholders equity, and cash flows for each of the three years in the period ended February 2, 2008. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Fred s Inc. at February 2, 2008 and February 3, 2007, and the results of its operations and its cash flows for each of the three years in the period ended February 2, 2008**,** in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, in the year ended February 2, 2008 the Company adopted Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes and in the year ended February 3, 2007, the Company adopted Statements of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment, Statements of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, and SEC Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in the Current Year Financial Statements.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Fred s Inc. internal control over financial reporting as of February 2, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated April 16, 2008 expressed an unqualified opinion thereon.

BDO Seidman, LLP
Memphis, Tennessee
April 16, 2008

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Fred s, Inc.
Consolidated Balance Sheets
(in thousands, except for number of shares)

	February 2, 2008	February 3, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 10,266	$ 2,475
Inventories	320,268	304,969
Receivables, less allowance for doubtful accounts of $879 and $719, respectively	30,972	29,097
Other non trade receivables	20,536	18,953
Prepaid expenses and other current assets	11,792	12,224
Total current assets	393,834	367,718
Property and equipment, at depreciated cost	145,985	138,031
Equipment under capital leases, less accumulated amortization of $4,836, and $4,578, respectively	132	390
Other noncurrent assets, net	10,621	9,570
Total assets	$ 550,572	$ 515,709
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 70,416	$ 64,349
Current portion of indebtedness	159	385
Current portion of capital lease obligations	126	352
Accrued expenses and other	39,469	42,159
Deferred income taxes	13,151	16,396
Income taxes payable		4,188
Total current liabilities	123,321	127,829
Long-term portion of indebtedness	35,653	2,216
Deferred income taxes	6,698	12,425
Long-term portion of capital lease obligations		115
Other non-current liabilities	12,841	3,856
Total liabilities	178,513	146,441
Commitments and contingencies (Notes 2,5 and 9)		
Shareholders equity:		
Preferred stock, nonvoting, no par value, 10,000,000 shares authorized, none outstanding		

Preferred stock, Series A junior participating nonvoting, no par value, 224,594 shares authorized, none outstanding		
Common stock, Class A voting, no par value, 60,000,000 shares authorized, 39,880,836 shares and 40,068,953 shares issued & outstanding, respectively	135,335	135,803
Common stock, Class B nonvoting, no par value, 11,500,000 shares authorized, none outstanding		
Retained earnings	235,684	232,382
Accumulated other comprehensive income	1,040	1,083
Total shareholders equity	372,059	369,268
Total liabilities and shareholders equity	$ 550,572	$ 515,709

See accompanying notes to Consolidated Financial Statements.

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Fred s, Inc.
Consolidated Statements of Income and Comprehensive Income
(in thousands, except per shares amounts)

	For the Years Ended		
	February 2, 2008	**February 3, 2007**	**January 28, 2006**
Net sales	$ 1,780,923	$ 1,767,239	$ 1,589,342
Cost of goods sold	1,290,680	1,272,320	1,141,105
Gross profit	490,243	494,919	448,237
Depreciation and amortization	28,614	29,102	27,755
Selling, general and administrative expenses	445,172	424,868	380,401
Operating income	16,457	40,949	40,081
Interest income	(567)	(68)	(176)
Interest expense	1,360	804	1,002
Income before income taxes	15,664	40,213	39,255
Income taxes	4,946	13,467	13,161
Net income	$ 10,718	$ 26,746	$ 26,094
Net income per share			
Basic	$ .27	$ .67	$ .66
Diluted	$ .27	$ .67	$ .66
Weighted average shares outstanding			
Basic	39,771	39,770	39,632
Diluted	39,882	39,858	39,772
Comprehensive income:			
Net income	$ 10,718	$ 26,746	$ 26,094
Other comprehensive income, net of tax:			
Postretirement plan adjustment	(43)		

Comprehensive income	$	10,675	$	26,746	$	26,094

See accompanying notes to Consolidated Financial Statements.

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Fred s, Inc.
Consolidated Statements of Changes in Shareholders Equity
(in thousands, except per share and share data)

	Common Stock Shares	Common Stock Amount	Retained Earnings	Unearned Compensation	Accumulated Other Comprehensive Income	Total
Balance, January 29, 2005	39,692,091	$ 132,511	$ 184,732	$ (2,697)	$	$ 314,546
Cash dividends paid ($.08 per share)			(3,183)			(3,183)
Restricted stock grants, cancellations and withholdings, net	(4,540)	78				78
Issuance of shares under employee stock purchase plan	32,583	469				469
Amortization of unearned compensation				431		431
Exercises of stock options	140,054	1,026				1,026
Income tax benefit on exercise of stock options		134				134
Net income			26,094			26,094
Balance, January 28, 2006	39,860,188	134,218	207,643	(2,266)		339,595
Cumulative effect of the adoption of SAB 108 (Note 1) (net of tax $597)			1,185			1,185
Cash dividends paid ($.08 per share)			(3,192)			(3,192)
Restricted stock grants, cancellations and withholdings, net	63,509	(38)				(38)
Issuance of shares under employee stock purchase plan	83,104	951				951
Adjustment to initially apply FAS 123 (R)		(2,266)		2,266		
Stock-based compensation		2,199				2,199
Exercises of stock options	62,152	684				684
Income tax benefit on exercise of stock options		55				55
Adjustment to initially apply SFAS No. 158 (net of tax)					1,083	1,083
Net income			26,746			26,746
Balance, February 3, 2007	40,068,953	135,803	232,382		1,083	369,268
Adjustment to initially apply FIN 48 as of February 4, 2007			(4,212)			(4,212)
Cash dividends paid ($.08 per share)			(3,204)			(3,204)
Restricted stock grants, cancellations and withholdings, net	64,036	(43)				(43)
Issuance of shares under employee stock purchase plan	71,294	667				667
Repurchase of shares	(426,500)	(4,371)				(4,371)
Stock-based compensation		2,116				2,116
Issuance of shares for real estate purchase	103,053	1,173				1,173
		(10)				(10)

Income tax benefit on exercise of stock options						
Adjustment for SFAS No. 158 (net of tax)					(43)	(43)
Net income			10,718			10,718
Balance, February 2, 2008	39,880,836	$ 135,335	$ 235,684	$	$ 1,040	$ 372,059

See accompanying notes to Consolidated Financial Statements.

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Fred s, Inc.
Consolidated Statements of Cash Flows
(in thousands)

	For the Years Ended		
	February 2, 2008	**February 3, 2007**	**January 28, 2006**
Cash flows from operating activities:			
Net income	$ 10,718	$ 26,746	$ 26,094
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	28,614	29,102	27,755
Net (gain) loss on asset disposition and impairments	(335)	594	
Provision for store closures and asset impairments	14,559	1,792	
Stock-based compensation	2,116	2,199	431
Provision for uncollectible receivables	160	21	69
LIFO reserve increase	1,657	1,571	2,493
Deferred income tax expense (benefit)	(6,604)	(547)	3,632
Issuance (net of cancellation) of restricted stock			78
Income tax benefit upon exercise of stock options	10	(55)	134
Provision for post retirement medical	(43)		
(Increase) decrease in operating assets:			
Receivables	(8,067)	(17,481)	(1,550)
Insurance receivables	1,537	2,713	
Inventories	(26,981)	(3,681)	(30,928)
Other assets	432	(1,434)	(1,011)
Increase (decrease) in operating liabilities:			
Accounts payable and accrued expenses	3,377	(3,433)	12,730
Income taxes payable	(3,508)	(2,550)	6,196
Other noncurrent liabilities	1,699	(234)	2,339
Net cash provided by operating activities	19,341	35,323	48,462
Cash flows from investing activities:			
Capital expenditures	(31,289)	(26,534)	(27,757)
Proceeds from asset dispositions	463	138	
Insurance recoveries for replacement assets	1,094	282	
Asset acquisition(primarily intangibles)	(1,663)	(3,439)	(3,154)
Net cash used in investing activities	(31,395)	(29,553)	(30,911)
Cash flows from financing activities:			
Payments of indebtedness and capital lease obligations	(1,656)	(1,367)	(694)
Proceeds from revolving line of credit	344,755	208,450	264,020
Payments on revolving line of credit	(316,293)	(211,983)	(281,412)
Excess tax benefits from stock-based compensation	(10)	55	
Proceeds from exercise of stock options and issuances under employee stock purchase plan	624	1,597	1,498

Repurchase of shares		(4,371)				
Dividends paid		(3,204)		(3,192)		(3,183)
Net cash provided by (used in) financing activities		19,845		(6,440)		(19,771)
Increase (decrease) in cash and cash equivalents		7,791		(670)		(2,220)
Cash and cash equivalents:						
Beginning of year		2,475		3,145		5,365
End of year	$	10,266	$	2,475	$	3,145
Supplemental disclosures of cash flow information:						
Interest paid	$	1,269	$	818	$	985
Income taxes paid	$	18,200	$	16,781	$	
Non-cash activities:						
Assets acquired through issuance of mortgage loan	$	6,065	$	100	$	1,058
Common stock issued for purchase of real estate	$	1,173	$		$	

See accompanying notes to Consolidated Financial Statements.

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Notes to Consolidated Financial Statements
(in thousands, except share and per share amounts)

NOTE 1 DESCRIPTION OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of business. The primary business of Fred s, Inc. and subsidiaries (the Company) is the sale of general merchandise through its retail discount stores and full service pharmacies. In addition, the Company sells general merchandise to its 24 franchisees. As of February 2, 2008, the Company had 692 retail stores and 296 pharmacies located in 15 states mainly in the Southeastern United States.

Consolidated Financial Statements. The Consolidated Financial Statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions are eliminated.

Fiscal year. The Company utilizes a 52 53 week accounting period which ends on the Saturday closest to January 31. Fiscal years 2007, 2006, and 2005, as used herein, refer to the years ended February 2, 2008, February 3, 2007, and January 28, 2006, respectively. The fiscal year 2006 had 53 weeks and the fiscal years 2007 and 2005 each had 52 weeks.

Use of estimates. The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America 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 and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates and such differences could be material to the financial statements.

Cash and cash equivalents. Cash on hand and in banks, together with other highly liquid investments which are subject to market fluctuations and having original maturities of three months or less, are classified as cash and cash equivalents. Included in accounts payable are outstanding checks in excess of funds on deposit, which totaled $4,052 at February 2, 2008 and $6,480 at February 3, 2007.

Allowance for doubtful accounts. The Company is reimbursed for drugs sold by its pharmacies by many different payors including insurance companies, Medicare and various state Medicaid programs. The Company estimates the allowance for doubtful accounts on a payor-specific basis, given its interpretation of the contract terms or applicable regulations. However, the reimbursement rates are often subject to interpretations that could result in payments that differ from the Company s estimates. Additionally, updated regulations and contract negotiations occur frequently, necessitating the Company s continual review and assessment of the estimation process. Senior management reviews accounts receivable on a quarterly basis to determine if any receivables are potentially uncollectible. The Company includes any accounts receivable balances that are determined to be uncollectible in our overall allowance for doubtful accounts. After all attempts to collect a receivable have failed, the receivable is written off against the allowance account.

Inventories. Merchandise inventories are valued at the lower of cost or market using the retail first-in, first-out (FIFO) method for goods in our stores and the cost first-in, first-out (FIFO) method for goods in our distribution centers. The retail inventory method is a reverse mark-up, averaging method which has been widely used in the retail industry for many years. This method calculates a cost-to-retail ratio that is applied to the retail value of inventory to determine the cost value of inventory and the resulting cost of goods sold and gross margin. The assumption that the retail inventory method provides for valuation at lower of cost or market and the inherent uncertainties therein are discussed in the following paragraphs.

In order to assure valuation at the lower of cost or market, the retail value of our inventory is adjusted on a consistent basis to reflect current market conditions. These adjustments include increases to the retail value of inventory for initial markups to set the selling price of goods or additional markups to adjust pricing for inflation and decreases to the retail value of inventory for markdowns associated with promotional, seasonal or other declines in the market value. Because these adjustments are made on a consistent basis and are based on current prevailing market conditions, they approximate the carrying value of the inventory at net realizable value (market value). Therefore, after applying the cost to retail ratio, the cost value of our inventory is stated at the lower of cost or market as is prescribed by U.S. GAAP.

Because the approximation of net realizable value (market value) under the retail inventory method is based on estimates such as markups, markdowns and inventory losses (shrink), there exists an inherent uncertainty in the final determination of inventory cost and gross margin. In order to mitigate that uncertainty, the Company has a formal review by product class which considers such variables as current market trends, seasonality, weather patterns and age of merchandise to ensure that markdowns are taken currently, or a markdown reserve is established to cover future anticipated markdowns. This review also considers current pricing trends and inflation to ensure that markups are taken if necessary. The estimation of inventory losses (shrink)is a significant element in approximating the carrying value of inventory at net realizable value, and as such the following paragraph describes our estimation method as well as the steps we take to mitigate the risk that this estimate in the determination of the cost value of inventory.

The Company calculates inventory losses (shrink) based on actual inventory losses occurring as a result of physical inventory counts during each fiscal period and estimated inventory losses occurring between yearly physical inventory counts. The estimate for shrink occurring in the interim period between physical counts is calculated on a store-specific basis and is based on history, as well as performance on the most recent physical count. It is calculated by multiplying each store s shrink rate, which is based on the previously mentioned factors, by the interim period s sales for each store. Additionally, the overall estimate for shrink is adjusted at the corporate level to a three-year historical average to ensure that the overall shrink estimate is the most accurate approximation of shrink based on the Company s overall history of shrink. The three-year historical estimate is calculated by dividing the book to physical inventory adjustments for the trailing 36 months by the related sales for the same period. In order to reduce the uncertainty inherent in the shrink calculation, the Company first performs the calculation at the lowest practical level (by store) using the most current performance indicators. This ensures a more reliable number, as opposed to using a higher level aggregation or percentage method. The second portion of the calculation ensures that the extreme negative or positive performance of any particular store or group of stores does not skew the overall estimation of shrink. This portion of the calculation removes additional uncertainty by eliminating short-term peaks and valleys that could otherwise cause the underlying carrying cost of inventory to fluctuate unnecessarily. The Company has not experienced any significant change in shrink as a percentage of sales from year to year during the subject reporting periods.

Management believes that the Company s Retail Inventory Method provides an inventory valuation which reasonably approximates cost and results in carrying inventory at the lower of cost or market. For pharmacy inventories, which were approximately $31.1 million and $36.4 million at February 2, 2008 and February 3, 2007, respectively, cost was determined using the retail LIFO (last-in, first-out) method in which inventory cost is maintained using the Retail Inventory Method, then adjusted by application of the Producer Price Index published by the U.S. Department of Labor for the cumulative annual periods. The current cost of inventories exceeded the LIFO cost by approximately $15.4 million at February 2, 2008 and $13.8 million at February 3, 2007. The LIFO reserve increased by approximately $1.6 million, $1.6 million, and $2.5 million, during 2007, 2006, and 2005, respectively.

The Company has historically included an estimate of inbound freight and certain general and administrative expenses in merchandise inventory as prescribed by Generally Accepted Accounting Principles. These costs include activities surrounding the procurement and storage of merchandise inventory such as buying, warehousing, and accounting, as well as inbound freight. During the second quarter which ended August 4, 2007, we revised our estimate to include certain costs internally captured within our Merchandise Planning, Information Technology and Human Resources departments as they relate to the inventory functions and support of procurement and storage. This revision follows growth in the role of these departments in support of the procurement and warehousing functions, including additional personnel hired over the

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past few quarters. Further, our Merchandise Planning department has evolved from being previously included within the buying function to a stand alone function with responsibility for inbound logistics and commodity procurement. The total amount of expenses and inbound freight included in merchandise inventory at February 2, 2008 is $21.9 million, with the corresponding amount of $19.8 million at February 3, 2007.

The Company recorded a year end below-cost inventory adjustment of approximately $10.0 million in cost of goods sold in the consolidated statements of income for the year ended February 2, 2008 to value inventory at the lower of cost or market in the stores impacted by the Company s plan to close approximately 75 stores in fiscal 2008.

For the year ended February 3, 2007, the Company recorded a year end below-cost inventory adjustment of approximately $2.1 million included in cost of goods sold in the consolidated statements of income to reflect the impact of the Company s plans to liquidate the boys and girls apparel departments and to record a markdown related to the closure of approximately 20 stores which occurred in fiscal 2007.

Property and equipment. Property and equipment are carried at cost. Depreciation is recorded using the straight-line method over the estimated useful lives of the assets. Improvements to leased premises are depreciated using the straight-line method over the shorter of the initial term of the lease or the useful life of the improvement. Leasehold improvements added late in the lease term are depreciated over the shorter of the remaining term of the lease (including the upcoming renewal option, if the renewal is reasonably assured) or the useful life of the improvement, whichever is lesser. Gains or losses on the sale of assets are recorded at disposal. The following average estimated useful lives are generally applied:

	Estimated Useful Lives
Building and building improvements	8 - 30 years
Furniture, fixtures and equipment	3 - 10 years
Leasehold improvements	3 - 10 years or term of lease, if shorter
Automobiles and vehicles	3 - 5 years
Airplane	9 years

Assets under capital leases are depreciated in accordance with the Company s normal depreciation policy for owned assets or over the lease term (regardless of renewal options), if shorter, and the charge to earnings is included in depreciation expense in the Consolidated Financial Statements.

Leases. Certain operating leases include rent increases during the initial lease term. For these leases, the Company recognizes the related rental expense on a straight-line basis over the term of the lease (which includes the pre-opening period of construction, renovation, fixturing and merchandise placement) and records the difference between the amounts charged to operations and amounts paid as a rent liability. Rent is recognized on a straight-line basis over the lease term, which includes any rent holiday period.

The Company recognizes contingent rental expense when the achievement of specified sales targets are considered probable in accordance with EITF Issue 98-9, Accounting for Contingent Rent. The amount expensed but not paid as of February 2, 2008 and February 3, 2007 was approximately $1.1 million and $1.4 million, respectively, and is included in Accrued expenses and other in the consolidated balance sheet (See Note 2).

The Company occasionally receives reimbursements from landlords to be used towards construction of the store the Company intends to lease. The reimbursement is primarily for the purpose of performing work required to divide a much larger location into smaller segments, one of which the Company will use for its store. This work could include the addition or demolition of walls, separation of plumbing, utilities, electric work, entrances (front and back) and other work as required. Leasehold improvements are recorded at their gross costs including items reimbursed by landlords. The reimbursements are initially recorded as a deferred credit and then amortized as a reduction of rent expense over the initial lease term.

Based upon an overall analysis of store performance and expected trends, we periodically evaluate the need to close underperforming stores. When we determine that an underperforming store should be closed and a lease obligation still exists, we record the estimated future liability associated with the rental obligation on the date the store is closed in accordance with SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities. Liabilities are computed based at the point of closure for the present value of any remaining operating lease obligations, net of estimated sublease income, and at the communication date for severance and other exit costs, as prescribed by SFAS 146. The assumptions in calculating the liability include the timeframe expected to terminate the lease agreement, estimates related to the sublease of potential closed locations, and estimation of other related exit costs. If the actual timing and the potential termination costs or realization of sublease income differ from our estimates, the resulting liabilities could vary from recorded amounts. We periodically review the liability for closed stores and make adjustments when necessary.

Impairment of Long-lived assets. The Company s policy is to review the carrying value of all long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable. In accordance with Statement of Financial Accounting Standards (SFAS) 144, Accounting for the Impairment or Disposal of Long-Lived Assets, we review for impairment all stores open or remodeled for more than two years. Impairment results when the carrying value of the assets exceeds the undiscounted future cash flows over the life of the lease. Our estimate of undiscounted future cash flows over the lease term is based upon historical operations of the stores and estimates of future store profitability which encompasses many factors that are subject to management s judgment and are difficult to predict. If a long-lived asset is found to be impaired, the amount recognized for impairment is equal to the difference between the carrying value and the asset s fair value. The fair value is based on estimated market values for similar assets or other reasonable estimates of fair market value based upon management s judgment.

In the fourth quarter of 2007, the Company recorded approximately $4.6 million in selling, general and administrative expense in the consolidated statements of income to reflect impairment charges for furniture and fixtures and leasehold improvements relating to planned fiscal 2008 store closures.

Vendor rebates and allowances. The Company receives vendor rebates for achieving certain purchase or sales volume and receives vendor allowances to fund certain expenses. The Emerging Issues Task Force (EITF) Issue No. 02-16, Accounting by a Customer (including a Reseller) for Certain Consideration Received from a Vendor (EITF 02-16) is effective for arrangements with vendors initiated on or after January 1, 2003. EITF 02-16 addresses the accounting and income statement classification for consideration given by a vendor to a retailer in connection with the sale of the vendor s products or for the promotion of sales of the vendor s products. The EITF concluded that such consideration received from vendors should be reflected as a decrease in prices paid for inventory and recognized in cost of sales as the related inventory is sold, unless specific criteria are met qualifying the consideration for treatment as reimbursement of specific, identifiable incremental costs. The provisions of this consensus have been applied prospectively.

For vendor funding arrangements that were entered into prior to December 31, 2002 and have not been modified subsequently, the Company recognizes a reduction to selling, general and administrative expenses or cost of goods sold when the vendor allowance is earned.

During the quarter ended October 29, 2005, the Company renewed its contract with its primary pharmaceutical wholesaler, AmerisourceBergen Corporation. The renewal of this contract impacted the Company s financial statements because of the application of the provisions of EITF 02-16. The effect on the financial statements, which occurred during the third quarter, was a deferral of the associated rebates against cost of sales of $2.2 million pretax (estimated at $0.03 per diluted share, after tax). This

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change in timing had no effect on cash flow for the quarter. While the contract was not due to mature until January 31, 2006, the renewal terms were positive to overall earnings and the Company has benefited through better pricing.

Prior to the close of the year ended February 3, 2007, the Company discovered additional rebates due from its primary pharmacy vendor (AmerisourceBergen) that were associated with purchases made from 2002 to 2006 and aggregated to approximately $2.8 million. In accordance with the transition guidance in the Securities and Exchange Commissions Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements in Current Year Financial Statements (SAB No. 108) the Company recorded, net of tax, the prior year effects ($1.2 million) of the misstatement as a cumulative adjustment to the retained earnings in the Stockholders Equity Section. This treatment is directed in the guidance for amounts that are deemed immaterial to the respective prior years statements, as these amounts were to the years mentioned previously. The $1.0 million (pretax) related to fiscal 2006 was recognized in that year s income for the quarterly period ended February 3, 2007.

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108 (SAB 108). Due to diversity in practice among registrants, SAB 108 expresses SEC staff views regarding the process by which misstatements in financial statements are evaluated for purposes of determining whether financial statement restatement is necessary. SAB 108 is effective for fiscal years ending after November 15, 2006, and early application is permitted. The Company adopted SAB 108 for the fiscal year ended February 3, 2007. See Note 1 to the Consolidated Financial Statements for further discussion.

The following table summarizes the effects of applying the guidance in SAB 108 (in thousands):

	Period in which the Misstatement Originated (1)			
	Cumulative Prior to January 31 2004	January 29 2005	January 28 2006	Adjustment recorded as of February 3 2007
Other non trade receivables (2)	$ 674	$ 485	$ 623	$ 1,782
Income taxes payable (3)	(226)	(162)	(209)	(597)
Impact on net income (4)	$ 448	$ 323	$ 414	
Retained earnings (5)				$ 1,185

(1) The Company quantified these errors under both the roll-over and iron- curtain methods and concluded that they were immaterial to the respective periods.

(2) As a result of the misstatement described above, the Company s cost of goods sold was overstated by approximately $0.7 million in years 2002 to 2003, $0.5 million in 2004, and $0.6 million in 2005. The Company recorded an increase in other non trade receivables of $1.8 million as of February 3, 2007 with a corresponding increase in retained earnings to correct these misstatements.

(3) As a result of the misstatement described above, the Company s income tax expense was understated by $0.2 million in years 2002 to 2003, $0.2 million in 2004, and $0.2 million in 2005. The Company recorded an increase in

income taxes payable of $0.6 million as of February 3, 2007 with a corresponding decrease in retained earnings to correct these misstatements.

(4) Represents the net understatement of net income for the indicated periods resulting from these misstatements.

(5) Represents the net increase to retained earnings as of February 3, 2007 to record as a prior period adjustment.

Selling, general and administrative expenses. The Company includes buying, warehousing, distribution, depreciation and amortization and occupancy costs in selling, general and administrative expenses.

Advertising. In accordance with The American Institute of Certified Public Accountants Statement of Position No. 93-7, Reporting on Advertising Costs (AICPA SOP 93-7), the Company charges advertising, including production costs, to selling, general and administrative expense on the first day of the advertising period. Gross advertising expenses for 2007, 2006, and 2005, were \$27.6 million, \$27.4 million, and \$22.3 million, respectively. Gross advertising expenses were reduced by vendor cooperative advertising allowances of \$1.5 million, \$1.1 million, and \$.5 million for 2007, 2006, and 2005, respectively. It would be the Company s intention to incur a similar amount of advertising expense as in prior years and in support of our stores even if we did not receive support from our vendors in the form of cooperative adverting programs.

Preopening costs. The Company charges to expense the preopening costs of new stores as incurred. These costs are primarily labor to stock the store, rent, preopening advertising, store supplies and other expendable items.

Revenue Recognition. The Company markets goods and services through Company owned stores and 24 franchised stores as of February 2, 2008. Net sales includes sales of merchandise from Company owned stores, net of returns and exclusive of sales taxes. Sales to franchised stores are recorded when the merchandise is shipped from the Company s warehouse. Revenues resulting from layaway sales are recorded upon delivery of the merchandise to the customer. The Company also sells gift cards for which the revenue is recognized at time of redemption. The Company records a gift card liability on the date the gift card is issued to the customer. Revenue is recognized and the gift card liability is reduced as the customer redeems the gift card. The Company will recognize as revenue when the likelihood of the gift card being redeemed is remote (gift card breakage). The Company has not recognized any revenue from gift card breakage since the inception of the program in May 2004 and does not expect to record any gift card breakage revenue until there is more certainty regarding our ability to retain such amounts in light of current consumer protection and state escheatment laws.

In addition, the Company charges the franchised stores a fee based on a percentage of their purchases from the Company. These fees represent a reimbursement for use of the Fred s name and other administrative costs incurred on behalf of the franchised stores and are therefore netted against selling, general and administrative expenses. Total franchise income for 2007, 2006, and 2005 was \$2,008, \$2,019, and \$1,891, respectively.

Other intangible assets. Other identifiable intangible assets, which are included in other noncurrent assets, primarily represent customer lists associated with acquired pharmacies and are being amortized on a straight-line basis over five years. Intangibles, net of accumulated amortization, totaled \$6,139 at February 2, 2008, and \$6,975 at February 3, 2007. Accumulated amortization at February 2, 2008 and February 3, 2007 totaled \$13,089 and \$10,675 respectively. Amortization expense for 2007, 2006, and 2005, was \$2,414, \$2,663, and \$2,180, respectively. Estimated amortization expense for each of the next 5 years is as follows: 2008 \$2,328, 2009 - \$1,881, 2010 \$1,235, 2011 \$530, and 2012- \$165.

Financial instruments. At February 2, 2008, the Company did not have any outstanding derivative instruments. The recorded value of the Company s financial instruments, which include cash and cash equivalents, receivables, accounts payable and indebtedness, approximates fair value. The following methods and assumptions were used to estimate fair value of each class of financial instrument: (1) the carrying amounts of current assets and liabilities approximate fair value because of the short maturity of those instruments and (2) the fair value of the Company s indebtedness is estimated based on the current borrowing rates available to the Company for bank loans with similar terms and average maturities. Most of our indebtedness is under variable interest rates.

Insurance reserves. The Company is largely self-insured for workers compensation, general liability and employee medical insurance. The Company s liability for self-insurance is determined based on claims known at the time of determination of the reserve and estimates for future payments against incurred losses and claims that have been incurred but not reported. Estimates for future claims costs include

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uncertainty because of the variability of the factors involved, such as the type of injury or claim, required services by the providers, healing time, age of claimant, case management costs, location of the claimant, and governmental regulations. These uncertainties or a deviation in future claims trends from recent historical patterns could result in the Company recording additional expenses or expense reductions that might be material to the Company s results of operations. The Company carries additional coverage for excessive or catastrophic claims with stop loss limits of $250,000 for property and general liability and $200,000 for employee medical. The Company s insurance reserve was $8.2 million and $8.6 million on February 2, 2008 and February 3, 2007, respectively. Changes in the reserve during fiscal 2007 were attributable to additional reserve requirements of $38.3 million netted with reserve utilization of $37.7 million.

Stock-based compensation. Effective January 29, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123(R), Share-Based Payment , using the modified prospective transition method. Under this method, compensation expense recognized post adoption includes: (1) compensation expense for all share-based payments granted prior to, but not yet vested as of, January 29, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123, and (2) compensation cost for all share-based payments granted subsequent to January 29, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). Results for prior periods have not been restated.

In November 2005, FASB issued Staff Position No. FAS 123(R)-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards (FSP FAS 123R-3). Effective January 29, 2006, the Company elected to adopt the alternative transition method provided in FSP FAS 123R-3 for calculating the income tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in-capital pool (APIC Pool) related to the income tax effects of stock based compensation, and for determining the subsequent impact on the APIC pool and consolidated statements of cash flows of the income tax effects of stock-based compensation awards that are outstanding upon adoption of SFAS 123(R).

SFAS 123(R) also requires the benefits of income tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required prior to SFAS 123(R). The impact of adopting SFAS 123(R) on future results will depend on, among other things, levels of share-based payments granted in the future, actual forfeiture rates and the timing of option exercises.

Prior to January 28, 2006, the Company accounted for share-based payments using the intrinsic-value-based recognition method prescribed by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25). As stock options were granted at an exercise price equal to the market value of the underlying common stock on the date of grant, no stock option compensation expense was reflected in net income prior to adopting SFAS 123(R).

Stock-based compensation expense, post adoption of SFAS 123(R), is based on awards ultimately expected to vest, and therefore has been reduced for estimated forfeitures. Forfeitures are estimated at the time of grant based on the Company s historical forfeiture experience and will be revised in subsequent periods if actual forfeitures differ from those estimates. For periods prior to 2006, the Company in its proforma disclosures under SFAS 123, recognized forfeitures as they occurred.

The following represents total stock based compensation expense (a component of selling, general and administrative expenses) recognized in the consolidated financial statements *(in thousands)*:

	2007	**2006**
Stock option expense	$ 1,312	$ 1,408
Restricted stock expense	591	512
ESPP expense	213	279
Total stock-based compensation	2,116	2,199
Income tax benefit on stock-based compensation	$ 340	$ 210

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As a result of adopting SFAS 123(R), the Company s income before income taxes and net income for fiscal year 2006, were $1.7 million and $1.7 million lower, respectively, than if it had continued to account for share-based compensation under APB 25. Basic and diluted earnings per share for fiscal year 2006 were $.04 and $.04 lower respectively, than if the Company had continued to account for share-based compensation under APB 25.
The following table illustrates the effect on 2005 net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 123(R) to stock based employee compensation.

(Amounts in thousands, except per share data)	**2005**
Net income, as reported	$ 26,094
Less SFAS No. 123 pro forma compensation expense, net of income taxes	(794)
SFAS No. 123 pro forma Net income	$ 25,300
Basic earnings per share	
As reported	$ 0.66
Pro forma	0.64
Diluted earnings per share	
As reported	0.66
Pro forma	0.64

Amounts for the year ended February 2, 2008 and February 3, 2007 are not presented in this table because those amounts were recorded in accordance with SFAS No. 123 (R) and are recognized in the Consolidated Financial Statements.
The amounts in this table have been adjusted from the amounts reported in our Annual Report on Form 10-K for the fiscal year ended January 28, 2006 to be calculated following the same method that has been utilized under SFAS No. 123(R). The total impact of the change was to increase the incremental stock option expense per SFAS No. 123(R), net of taxes by $.4 million.
The Company uses the Modified Black-Scholes Option Valuation Model (BSM) to measure the fair value of stock options granted to employees. The BSM option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock volatility and option life. Because the Company s employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

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The fair value of each option granted is estimated on the date of grant using the BSM with the following weighted average assumptions:

	2007	2006	(Pro Forma) 2005
Stock Options			
Expected volatility	42.8%	41.4%	46.6%
Risk-free interest rate	4.1%	4.8%	4.3%
Expected option life (in years)	5.8	5.9	5.3
Expected dividend yield	0.4%	0.4%	0.5%
Weighted average fair value at grant date	$4.68	$6.01	$7.35
Employee Stock Purchase Plan			
Expected volatility	37.2%	38.7%	41.4%
Risk-free interest rate	4.7%	4.8%	4.3%
Expected option life (in years)	0.63	0.63	0.5
Expected dividend yield	0.38%	0.3%	0.2%
Weighted average fair value at grant date	$3.31	$4.31	$3.37

The following is a summary of the methodology applied to develop each assumption:

Expected Volatility   This is a measure of the amount by which a price has fluctuated or is expected to fluctuate. The Company uses actual historical changes in the market value of our stock to calculate expected price volatility because management believes that this is the best indicator of future volatility. The Company calculates weekly market value changes from the date of grant over a past period representative of the expected life of the options to determine volatility. An increase in the expected volatility will increase compensation expense.

Risk-free Interest Rate   This is the yield of a U.S. Treasury zero-coupon bond issue effective at the grant date with a remaining term equal to the expected life of the option. An increase in the risk-free interest rate will increase compensation expense.

Expected Lives   This is the period of time over which the options granted are expected to remain outstanding and is based on historical experience. Options granted have a maximum term of seven and one-half years. An increase in the expected life will increase compensation expense.

Dividend Yield   This is based on the historical yield for a period equivalent to the expected life of the option. An increase in the dividend yield will decrease compensation expense.

Forfeiture Rate   This is the estimated percentage of options granted that are expected to be forfeited or cancelled before becoming fully vested. This estimate is based on historical experience. An increase in the forfeiture rate will decrease compensation expense.

Income taxes. The Company reports income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. Under SFAS No. 109, the asset and liability method is used for computing future income tax consequences of events, which have been recognized in the Company s Consolidated Financial Statements or income tax returns. Deferred income tax expense or benefit is the net change during the year in the

Company s deferred income tax assets and liabilities. In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement 109. Effective February 4, 2007, we adopted FIN 48, which clarifies the accounting for uncertainties in income taxes recognized in the Company s financial statements in accordance with SFAS No. 109 by defining the criterion that an individual tax position must meet in order to be recognized in the financial statements. FIN 48 requires that the tax effects of a position be recognized only if it is more-likely-than-not to be sustained based solely on the technical merits as of the reporting date.

Business segments. The Company operates in a single reportable operating segment.

Comprehensive income. Comprehensive income consists of two components, net income and other comprehensive income (loss). Other comprehensive income (loss) refers to gains and losses that under generally accepted accounting principles are recorded as an element of stockholders equity but are excluded from net income. The Company s accumulated other income includes the effect of adopting SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)(SFAS No. 158). See Note 9, Employee Benefit Plans , in the Notes to Consolidated Financial Statements for further discussion.

Reclassifications. Certain prior year amounts have been reclassified to conform to the 2007 presentation.

Recent Accounting Pronouncements. In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements . SFAS No. 157 provides a single definition of fair value, together with a framework for measuring it, and requires additional disclosure about the use of fair value to measure assets and liabilities. SFAS No. 157 also emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. Under SFAS No. 157, fair value measurements are required to be disclosed by level within that hierarchy. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. However, FASB Staff Position (FSP) No. FAS 157-2, Effective Date of FASB Statement No. 157, issued in February 2008, delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis, to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

The Company is in the process of determining the effect, if any, that the adoption of SFAS No. 157 will have on its results of operations or financial position.

In February 2007, the Financial Accounting Standards Board issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 , (SFAS No. 159). SFAS No. 159 allows companies the choice to measure many financial instruments and certain other items at fair value. This gives a company the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently reviewing the impact of SFAS No. 159, if any, on our Consolidated Financial Statements and expect to complete this evaluation in 2008.

In March 2007, the Emerging Issues Task Force (EITF) reached a consensus on issue number 06-10, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements, (EITF 06-10). EITF 06-10 provides guidance to help companies determine whether a liability for the postretirement benefit associated with a collateral assignment split-dollar life insurance arrangement should be recorded in accordance with either SFAS No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions (if, in substance, a postretirement benefit plan exists), or Accounting Principles Board Opinion No. 12 (if the arrangement is, in substance, an individual deferred compensation contract). EITF 06-10 also provides guidance on how a company should recognize and measure the asset in a collateral assignment split-dollar life insurance contract. EITF 06-10 is effective for fiscal years beginning after December 15, 2007, although early adoption is permitted. The Company has evaluated EITF 06-10 and has determined that it will have no impact on its results of operations or financial position.

In May 2007, the FASB issued FASB Staff Position No. FIN 48-1, Definition of Settlement in FASB Interpretation No. 48 (FSP FIN 48-1). FSP FIN 48-1 amends FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, to provide guidance on how an enterprise should determine whether a tax position is effectively settled for the purposes of recognizing previously unrecognized tax benefits. The Company adopted FIN 48-1 as of February 4, 2007 and is now required to apply the guidance provided in FSP FIN 48-1. The application of FSP FIN 48-1 has not had a material effect on the Company s financial position, results of operations, or cash flows.

In June 2007, the Emerging Issues Task Force (EITF) of the FASB ratified their consensus position 06-11 (EITF 06-11), Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards. EITF 06-11 provides guidance on how a company should recognize the income tax benefit received on dividends that are paid to employees holding equity-classified nonvested shares, equity-classified nonvested share units, or equity-classified outstanding share options charged to retained earnings under FASB Statement 123(R), Share-Based Payment. The Company is required to apply the guidance provided in EITF 06-11 prospectively to income tax benefits of dividends on equity-classified employee share-based payment awards that are declared in fiscal years beginning after September 15, 2007. Early application of EITF 06-11 is permitted for the income tax benefit of dividends on equity-classified employee share-based payment awards that are declared in periods for which financial statements have not yet been issued. The Company is in the process of determining the effect, if any, that the adoption of EITF 06-11 will have on its results of operations or financial position.

In December 2007, the FASB issued FASB Statement No. 141 (R), Business Combinations (FAS 141(R)), which establishes accounting principles and disclosure requirements for all transactions in which a company obtains control over another business. Statement 141 (R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is in the process of determining the effect, if any, that the adoption of FAS 141 (R) will have on its results of operations or financial position.

In December 2007, the FASB issued FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements An Amendment of ARB No. 51. Statement 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Statement 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company is in the process of determining the effect, if any, that the adoption of FASB No. 160 will have on its results of operations or financial position.

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Note 2 Detail of Certain Balance Sheet Accounts

	2007	2006
Property and equipment, at cost:		
Buildings and building improvements	$ 88,459	$ 76,623
Leasehold improvements	50,859	45,097
Automobiles and vehicles	5,500	6,429
Airplane	4,697	4,697
Furniture, fixtures and equipment	224,734	216,448
	374,249	349,294
Less accumulated depreciation and amortization	(235,281)	(215,879)
	138,968	133,415
Construction in progress	1,034	353
Land	5,983	4,263
Total property and equipment, at depreciated cost	$ 145,985	$ 138,031

Depreciation expense totaled $25,942, $26,064, and $25,094, for 2007, 2006, and 2005, respectively.
During the second and third quarter of fiscal 2007, the Company acquired the land and buildings, occupied by thirteen Fred s stores which we had previously leased. In consideration for the thirteen properties, the Company paid cash of $4.417 million, issued 103,053 shares of our common stock valued at $1.173 million and assumed current debt of $.971 million and long term debt of $5.094 million.

	2007	2006
Other non trade receivables:		
Landlord receivables	$ 59	$ 1,529
Vendor receivables	13,276	14,489
Income tax receivable	4,018	28
Insurance receivable	1,058	877
Other	2,125	2,030
Total non trade receivables	$ 20,536	$ 18,953

	2007	2006
Prepaid expenses and other current assets		
Prepaid advertising	$ 701	$ 964
Prepaid insurance	1,630	1,451
Prepaid rent	4,424	4,458
Supplies	3,866	4,134
Other	1,171	1,217
Total prepaid expenses and other current assets	$ 11,792	$ 12,224

	2007	2006

Accrued expenses and other:		
Payroll and benefits	$ 10,573	$ 12,564
Sales and use taxes	6,333	7,906
Insurance	8,186	8,604
Deferred rent	4,683	5,657
Other	9,694	7,428
Total accrued expenses and other	$ 39,469	$ 42,159

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	2007	2006
Other non-current liabilities		
FIN 48 tax liability (Note 4)	$ 8,352	$
OPEB liability	539	591
Deferred income	3,950	3,265
Total other non-current liabilities	$ 12,841	$ 3,856

NOTE 3 INDEBTEDNESS

On October 30, 2007, the Company and Regions Bank entered into an amendment of their Revolving Loan and Credit Agreement (agreement) to provide an increase in the credit line from $50 million to $75 million and to extend the term until July 31, 2009. All other terms, conditions and covenants remained in place after the amendment. Borrowings under the Agreement bear interest at 1.5% below the prime rate or a LIBOR-based rate. Under the most restrictive covenants of the Agreement, the Company is required to maintain specified shareholders equity (which was $292.3 million at February 2, 2008) and net income levels. The Company is required to pay a commitment fee to the bank at a rate per annum equal to 0.15% on the unutilized portion of the revolving line commitment over the term of the Agreement. There were $30.6 million and $2.2 million of borrowings outstanding under the Agreement at February 2, 2008 and February 3, 2007, respectively. The increase in debt was due to an increase in inventory to improve in-stock positions and capital expenditures to acquire the land and building occupied by thirteen Fred s stores that we had previously leased. The weighted average interest rate on borrowings under Agreement was 5.76% and 5.93% at February 2, 2008 and February 3, 2007, respectively.

During the second and third quarter of fiscal 2007, the Company acquired the land and buildings, occupied by thirteen Fred s stores which we had previously leased. In consideration for the thirteen properties, the Company assumed debt that has fixed interest rates from 6.31% to 7.40%. The debt is collateralized by the land and building. The below table shows the long term debt related to these properties due for the next five years as of February 2, 2008:

(Dollars in thousands)			Payments due by year			
Contractual Obligations	Total	2008	2009	2010	2011	2012
Term debt	$1,161	$164	$176	$663	$158	$170

The Company financed the construction of its Dublin, Georgia distribution center with taxable industrial development revenue bonds issued by the City of Dublin and County of Laurens Development Authority. The Company purchased 100% of the issued bonds and intends to hold them to maturity, effectively financing the construction with internal cash flow. Because a legal right of offset exists, the Company has offset the investment in the bonds ($34.6 million) against the related liability and neither is reflected on the consolidated balance sheet.

NOTE 4 INCOME TAXES

The provision for income taxes consists of the following:

	2007	2006	2005
Current			
Federal	$ 10,886	$ 15,048	$ 10,666
State	664	(1,034)	(1,137)
	11,550	14,014	9,529
Deferred			
Federal	(5,354)	(1,135)	3,272

State	(1,250)	588	360
	(6,604)	(547)	3,632
	$ 4,946	$ 13,467	$ 13,161

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The income tax effects of temporary differences that give rise to significant portions of the deferred income tax assets and deferred income tax liabilities are presented below:

	2007	**2006**
Deferred income tax assets:		
Accrual for incentive compensation	$ 474	$ 1,529
Allowance for doubtful accounts	455	392
Insurance accruals	2,279	2,207
Other accruals	312	
Net operating loss carryforwards	5,119	5,043
Postretirement benefits other than pensions	287	323
Reserve for below cost inventory adjustment	3,964	334
Federal benefit on state reserves	2,656	
Amortization of intangibles	4,406	3,747
Total deferred income tax assets	19,952	13,575
Less: valuation allowance	(1,695)	(1,709)
Deferred income tax assets, net of valuation allowance	18,257	11,866
Deferred income tax liabilities:		
Property, plant, and equipment	(17,710)	(20,163)
Inventory valuation	(19,928)	(19,837)
Prepaid expenses	(468)	(687)
Total deferred income tax liability	(38,106)	(40,687)
Net deferred income tax liability	$ (19,849)	$ (28,821)

The net operating loss carryforwards are available to reduce state income taxes in future years. These carryforwards total approximately $122.2 million for state income tax purposes and expire at various times during the period 2008 ($1.5 million) through 2027.

During 2007, the valuation allowance decreased $14, and during 2006, the valuation allowance increased $821. Based upon expected future income, management believes that it is more likely than not that the results of operations will generate sufficient taxable income to realize the deferred income tax asset after giving consideration to the valuation allowance.

A reconciliation of the statutory federal income tax rate to the effective income tax rate is as follows:

	2007	2006	2005
Income tax provision at statutory rate	35.0%	35.0%	35.0%
Tax credits, principally jobs	(9.9)	(3.5)	(2.6)
State income taxes, net of federal benefit	(0.7)	(1.1)	(0.6)
Permanent differences	2.2	0.9	0.5
Uncertain tax positions	5.1	0.0	0.0
Change in valuation allowance	(0.1)	2.2	1.2
Effective income tax rate	31.6%	33.5%	33.5%

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No.109. We adopted FIN 48 as of February 4, 2007, the first day of fiscal 2007. This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No.

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109 and prescribes a minimum recognition threshold of more-likely-than-not to be sustained upon examination that a tax position must meet before being recognized in the financial statements. Under FIN 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, FIN 48 provides guidance on de-recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition.

As a result of the adoption of FIN 48, we recognized a cumulative effect adjustment of a $4.2 million decrease to beginning retained earnings and a reclassification of certain amounts between deferred income tax liabilities ($2.3 million decrease) and other non-current liabilities ($6.5 million increase, including $1.0 million of interest and penalties) to conform to the balance sheet presentation requirements of FIN 48. The Company increased the gross reserve for uncertain tax positions from $6.5 million to $7.3 million, a change of $0.8 million to disclose the gross liability rather than reflect the liability net of federal income tax benefit.

A reconciliation of the beginning and ending amount of the unrecognized tax benefits is as follows:

(in millions)		
Balance at February 4, 2007	$	7.3
Additions for tax position related to current year		1.5
Additions for tax position of prior years		.4
Reductions for tax position of prior years		(.8)
Settlements		
Balance at February 2, 2008	$	8.4

As of February 4, 2007, our liability for unrecognized tax benefits totaled $7.3 million, of which $0.5 million and $0.3 million were recognized as income tax benefit during the quarterly periods ending November 3, 2007 and February 2, 2008, respectively, as a result of a lapse in applicable statute of limitations. As of February 2, 2008, our liability for unrecognized tax benefits totaled $8.4 million and is recorded in our consolidated balance sheet with Other Liabilities, all of which, if recognized, would affect our effective tax rate.

FIN 48 further requires that interest and penalties required to be paid by the tax law on the underpayment of taxes should be accrued on the difference between the amount claimed or expected to be claimed on the tax return and the tax benefit recognized in the financial statements. The Company includes potential interest and penalties recognized in accordance with FIN 48 in the financial statements as a component of income tax expense. As of February 2, 2008, accrued interest and penalties related to our unrecognized tax benefits totaled $ 1.0 million and $ 0.4 million, respectively, and are both recorded in the consolidated balance sheet within Other non-current liabilities.

The Company files numerous consolidated and separate company income tax returns in the U.S. federal jurisdiction and in many U.S. state jurisdictions. With few exceptions, we are subject to U.S. federal, state, and local income tax examinations by tax authorities for years 2004-2006. However, tax authorities have the ability to review years prior to these to the extent we utilized tax attributes carried forward from those prior years.

NOTE 5 LONG-TERM LEASES

The Company leases certain of its store locations under noncancelable operating leases that require monthly rental payments primarily at fixed rates (although a number of the leases provide for additional rent based upon sales) expiring at various dates through 2029. Many of these leases contain renewal options and require the Company to pay taxes, maintenance, insurance and certain other operating expenses applicable to the leased properties. In addition, the Company leases various equipment and transportation equipment under noncancelable operating leases and

certain transportation equipment under capital leases. Total rent expense under operating leases was $54,539, $48,670, and $46,561, for 2007, 2006, and 2005, respectively. Total contingent rentals included in operating leases above was $1,150, $1,322, and $1,247, for 2007, 2006, and 2005, respectively.
Future minimum rental payments under all operating and capital leases as of February 2, 2008 are as follows:

	Operating Leases	Capital Leases
2008	$ 49,511	$ 129
2009	41,707	
2010	34,277	
2011	27,406	
2012	19,246	
Thereafter	31,209	
Total minimum lease payments	$ 203,356	129
Imputed interest		(3)
Present value of net minimum lease payments, shown as current portion of capital lease obligations in Balance Sheet		$ 126

The gross amount of property and equipment under capital leases was $4,967 at February 2, 2008 and February 3, 2007. Accumulated depreciation on property and equipment under capital leases at February 2, 2008 and February 3, 2007, was $4,836, and $4,578, respectively. Depreciation expense on assets under capital lease for 2007, 2006, and 2005, was $258, $375, and $481, respectively.

Related Party Transactions

During the year ended February 2, 2008, Atlantic Retail Investors, LLC, which is partially owned by Michael J. Hayes, a director and officer of the Company, purchased the land and buildings occupied by thirteen Fred s stores. The stores were purchased by Atlantic Retail Investors, LLC from an independent landlord/developer. Prior to the purchase by Atlantic Retail Investors, LLC the Company was offered the right to purchase the same stores and declined the offer. The terms and conditions regarding the leases on these locations are consistent in all material respects with other stores leases of the Company. The total rental payments related to these leases was $.585 million for the year ended February 2, 2008. Total future commitments under related party leases are $7.078 million.

NOTE 6 SHAREHOLDERS EQUITY

In 1998, the Company adopted a Shareholders Rights Plan which granted a dividend of one preferred share purchase right (a Right) for each common share outstanding at that date. Each Right represents the right to purchase one-hundredth of a preferred share of stock at a preset price to be exercised when any one individual, firm, corporation or other entity acquires 15% or more of the Company s common stock. The Rights will become dilutive at the time of exercise and will expire, if unexercised, in October 2008.

On March 6, 2002, the Company filed a Registration Statement on Form S-3 registering 750,000 shares of Class A common stock. The common stock may be used from time to time as consideration in the acquisition of assets, goods, or services for use or sale in the conduct of our business. As of January 28, 2006, the Company had 301,866 shares of Class A common stock available to be issued from the March 6, 2002 Registration Statement. During the second and third quarter of fiscal 2007, we sold in a private placement an aggregate of 103,053 shares of our Class A common stock to Summit Properties, LLC (Summit) pursuant to the exemptions from registration provided in Section 4(2) of the Securities Act of 1933, as amended (the Act), and Rule 506 of Regulation D promulgated thereunder. The shares were issued in connection with our acquisition of the membership interests of certain Limited Liability Companies and related real estate rights. The shares have subsequently been registered under the Act. We will not receive any proceeds from the resale of these shares.

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The private placement that we made in reliance on the exemptions from registration under Section 4(2) of the Act and Rule 506 of Regulation D thereunder did not involve any public offering of common stock. In addition, Summit provided us with written representations that it was an accredited investor within the meaning of Rule 501(e) of Regulation D, that it was a sophisticated investor and that it had the knowledge and experience necessary to evaluate the risks and merits of the investment in our common stock. In addition, Summit was solicited on a private and confidential basis in a manner not involving any general solicitation or advertising in compliance with Regulation D. As of February 2, 2008, the Company has 198,813 shares of Class A common stock available to be issued from the March 6, 2002 Registration Statement.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers.

On August 27, 2007, the Board of Directors approved a plan that authorized stock repurchases of up to 4.0 million shares of the Company s common stock. Under the plan, the Company may repurchase its common stock in open market or privately negotiated transactions at such times and at such prices as determined to be in the Company s best interest. These purchases may be commenced or suspended without prior notice depending on then-existing business or market conditions and other factors. The following table sets forth the amounts of our common stock purchased by the Company during the fiscal year ended February 2, 2008(amounts in thousands, except price data). The repurchased shares have been cancelled and returned to authorized but un-issued shares.

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs
August 27, 2007 September 10, 2007		$		4,000.0
September 11, 2007 October 3, 2007	190.1	$ 10.25	190.1	3,809.9
October 4, 2007 November 3, 2007	236.4	$ 10.24	236.4	3,573.5
November 4, 2007 February 2, 2008		$		3,573.5
Total	426.5	$ 10.25	426.5	

NOTE 7 EQUITY INCENTIVE PLANS

Incentive stock option plan. The Company has a long-term incentive plan, which was approved by Fred s stockholders, under which an aggregate of 2,057,344 shares as of February 2, 2008 (2,326,713 shares as of February 3, 2007) are available to be granted. These options expire five years to seven and one-half years from the date of grant. Options outstanding at February 2, 2008 expire in 2008 through 2014.

The Company grants stock options to key employees including executive officers, as well as other employees, as prescribed by the Compensation Committee (the Committee) of the Board of Directors. The number of options granted is directly linked to the employee s job classification. Options, which include non-qualified stock options and incentive stock options, are rights to purchase a specified number of shares of Fred s common stock at a price fixed by the Committee. Stock options granted have an exercise price equal to the market price of Fred s common stock on the date of grant. The exercise price for stock options issued under the plan that qualify as incentive stock options within the meaning of Section 422(b) of the Code shall not be less than 100% of the fair value as of the date of grant. The option exercise price may be satisfied in cash or by exchanging shares of Fred s common stock owned by the optionee for at least six months, or a combination of cash and shares. Options have a maximum term of five to seven and one-half years from the date of grant. Options granted under the plan generally become exercisable ratably over five years or ten percent during each of the first four years on the anniversary date

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and sixty percent on the fifth anniversary date. The rest vest ratably over the requisite service period. Stock option expense is generally recognized using the graded vesting attribution method. The plan contains a non-compete provision and a provision that if the Company meets or exceeds a specified operating income margin during the most recently completed fiscal year that the annual vesting percentage will accelerate from ten to twenty percent during that vesting period. The plan also provides for annual stock grants at the fair value of the stock on the grant date to non-employee directors according to a non-discretionary formula. The number of shares granted is dependent upon current director compensation levels.

Employee Stock Purchase Plan. The 2004 Employee Stock Purchase Plan (the 2004 Plan), which was approved by Fred s stockholders, permits eligible employees to purchase shares of our common stock through payroll deductions at the lower of 85% of the fair market value of the stock at the time of grant or 85% of the fair market value at the time of exercise. There were 71,294, 83,104 and 32,583 shares issued during fiscal years 2007, 2006 and 2005, respectively. There are 1,410,928 shares approved to be issued under the 2004 Plan and as of February 2, 2008 there were 1,223,947 shares available.

Stock Options. The following table summarizes stock option activity from January 29, 2005 through February 2, 2008:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (Thousands)
Outstanding at January 29, 2005	**1,221,357**	**$16.28**	**3.8**	**$1,894**
Granted	241,800	$15.37		
Forfeited / Cancelled	(135,896)	$18.05		
Exercised	(137,242)	$ 7.37		
Outstanding at January 28, 2006	**1,190,019**	**$16.92**	**4.0**	**$ 694**
Granted	328,025	$13.30		
Forfeited / Cancelled	(352,828)	$15.15		
Exercised	(62,152)	$11.01		
Outstanding at February 3, 2007	**1,103,064**	**$16.74**	**4.2**	**$ 298**
Granted	270,552	$10.97		
Forfeited / Cancelled	(157,165)	$17.19		
Exercised	0			
Outstanding at February 2, 2008	**1,216,451**	**$15.40**	**4.6**	**$ 0**
Exercisable at February 2, 2008	**387,438**	**$17.26**	**2.9**	**$ 0**

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the excess of Fred s closing stock price on the last trading day of the fiscal year end and the exercise price of the option multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on that date. This amount changes based on changes in the market value of Fred s stock. The total pre-tax intrinsic value of options exercised during the year ended February 3, 2007 was $.1 million. Cash received from the exercise of stock options during the year ended February 3, 2007 totaled $.7 million and the related tax benefits recognized from the exercise of stock options totaled $.1 million. There were no options exercised during the year ended February 2, 2008. The total fair value of options vested during the years ended February 2, 2008 and February 3, 2007 was $1 million and $.7 million, respectively. As of February 2, 2008, total unrecognized stock-based compensation expense net of estimated forfeitures related to non-vested stock options was approximately $1.8 million, which is expected to be recognized over a weighted average period of approximately 3.5 years.

The following table summarizes information about stock options outstanding at February 2, 2008:

Range of Exercise Prices	Options Outstanding Shares	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Options Exercisable Shares	Weighted Average Exercise Price
$10.61 to $14.60	676,311	6.3	$12.64	142,469	$13.99
$14.68 to $20.60	485,940	2.7	$18.05	204,119	$17.96
$23.05 to $33.49	54,200	1.7	$25.98	40,850	$25.14
	1,216,451	4.6	$15.40	387,438	$17.26

Restricted Stock. The Company s equity incentive plans also allow for granting of restricted stock having a fixed number of shares at a purchase price that is set by the Compensation Committee of the Company s Board of Directors, which purchase price may be set at zero, to certain executive officers, directors and key employees. The Company calculates compensation expense as the difference between the market price of the underlying stock on the date of grant and the purchase price if any. Restricted shares granted under the plan have various vesting types, which include cliff vesting and graded vesting with a requisite service period of three to ten years. Restricted stock has a maximum term of five to ten years from grant date. Compensation expense is recorded on a straight-line basis for shares that cliff vest and under the graded vesting attribution method for those that have graded vesting.

The following table summarizes restricted stock from January 29, 2005 through February 2, 2008:

	Number of Shares	Weighted Average Grant Date Fair Value
Non-vested Restricted Stock at January 29, 2005	**183,760**	**$15.61**
Granted	5,750	$14.44
Forfeited / Cancelled	(13,016)	$15.81
Vested	(3,962)	$17.74
Non-vested Restricted Stock at January 28, 2006	**172,532**	**$15.51**
Granted	92,182	$13.93
Forfeited / Cancelled	(25,293)	$15.12
Vested	(9,570)	$10.98
Non-vested Restricted Stock at February 3, 2007	**229,851**	**$15.03**
Granted	81,176	$10.47
Forfeited / Cancelled	(15,713)	$13.48
Vested	(9,679)	$16.59
Non-vested Restricted Stock at February 2, 2008	**285,635**	**$13.83**

The aggregate pre-tax intrinsic value of restricted stock outstanding as of February 2, 2008 is $2.8 million with a weighted average remaining contractual life of 6.3 years. The unrecognized compensation expense net of estimated forfeitures, related to the outstanding restricted stock is approximately $2.8 million, which is expected to be recognized over a weighted average period of approximately 5.7 years. The total fair value of restricted stock awards that vested during the years ended February 2, 2008 and February 3, 2007 was $.2 million and $.1 million, respectively.

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The unrecognized compensation expense related to outstanding restricted stock awards was recorded as unearned compensation in shareholders equity at January 28, 2006. With the adoption of SFAS 123 (R), the unrecognized compensation expense related to outstanding restricted stock awards granted prior to January 29, 2006 was charged to common stock.

NOTE 8 NET INCOME PER SHARE

Basic earnings per share excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if options to issue common stock were exercised into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. Restricted stock is considered contingently issuable and is excluded from the computation of basic earnings per share until it vests.

A reconciliation of basic earnings per share to diluted earnings per share follows:

	Year Ended								
	February 2, 2008			January 28, 2006			January 29, 2005		
	Income	Shares	Per Share Amount	Income	Shares	Per Share Amount	Income	Shares	Per Share Amount
Basic EPS	$ 10,718	39,771	$ .27	$ 26,746	39,770	$ .67	$ 26,094	39,632	$ .66
Effect of Dilutive Securities		111			88			140	
Diluted EPS	$ 10,718	39,882	$ .27	$ 26,746	39,858	$ .67	$ 26,094	39,772	$ .66

Options to purchase shares of common stock that were outstanding at the end of the respective fiscal year were not included in the computation of diluted earnings per share when the options exercise prices were greater than the average market price of the common shares. There were 1,216,451, 1,097,064, and 89,404 such options outstanding at February 2, 2008, February 3, 2007, and January 28, 2006.

NOTE 9 COMMITMENTS AND CONTINGENCIES

Commitments. The Company had commitments approximating $14.3 million at February 2, 2008 and $9.7 million at February 3, 2007 on issued letters of credit, which support purchase orders for merchandise. Additionally, the Company had outstanding letters of credit aggregating approximately $17.1 million at February 2, 2008 and $15.7 million at February 3, 2007 utilized as collateral for its risk management programs.

Salary reduction profit sharing plan. The Company has a defined contribution profit sharing plan for the benefit of qualifying employees who have completed one year of service and attained the age of 21. Participants may elect to make contributions to the plan up to a maximum of 15% of their compensation. Company contributions are made at the discretion of the Company s Board of Directors. Participants are 100% vested in their contributions and earnings thereon. Contributions by the Company and earnings thereon are fully vested upon completion of six years of service. The Company s contributions for 2007, 2006, and 2005, were $251, $160, and $142, respectively.

Postretirement benefits. The Company provides certain health care benefits to its full-time employees that retire between the ages of 62 and 65 with certain specified levels of credited service. Health care coverage options for retirees under the plan are the same as those available to active employees. The Company s change in benefit obligation based upon an actuarial valuation is as follows:

	February 2, 2008	February 3, 2007
Benefit obligation at beginning of year	$ 591	$ 731
Service cost	33	39
Interest cost	30	31
Actuarial (gain)	(82)	(165)
Benefits paid	(33)	(45)
Benefit obligation at end of year	$ 539	$ 591

The medical care cost trend used in determining this obligation is 7.5% effective December 1, 2006, decreasing annually before leveling at 5.0% in 2012. The below table illustrates a one-percentage-point increase or decrease in the healthcare cost trend rate assumed for postretirement benefits:

	For the Year Ended	
	February 2, 2008	February 3, 2007
Effect of health care trend rate:		
1% increase effect on accumulated benefit obligations	$ 47	$ 55
1% increase effect on periodic cost	7	9
1% decrease effect on accumulated benefit obligations	(42)	(50)
1% decrease effect on periodic cost	(6)	(8)

The discount rate used in calculating the obligation was 6.25% in 2007 and 5.75% in 2006.

Effective February 3, 2007, the Company began recognizing the funded status of its postretirement benefits plan in accordance with SFAS No. 158. SFAS No. 158 requires the Company to display the net over-or under funded position of a defined benefit postretirement plan as an asset or liability, with any unrecognized prior service costs, transition obligations or actuarial gains/losses reported as a component of accumulated other comprehensive income in stockholders equity. Prior to February 3, 2007, the Company had accounted for its postretirement benefits plan according to the provisions of SFAS No. 106, Employers Accounting for Postretirement Benefits Other than Pensions. The following table summarizes the effects from the adoption of SFAS No. 158 on individual line items in the Company s Consolidated Balance Sheet at February 3, 2007.

	Before Implementation of SFAS No. 158	Changes due to SFAS No. 158	After Implementation of SFAS No. 158
Long term deferred income taxes	$ 11,879	$ 546	$ 12,425
Other noncurrent liabilities	5,485	(1,629)	3,856
Total liabilities	$ 147,524	$ (1,083)	$ 146,441
Accumulated other comprehensive income, net of tax		1,083	1,083
Total stockholders equity	$ 368,185	$ 1,083	$ 369,268

The annual net postretirement cost is as follows:

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	For the Year Ended		
	February 2, 2008	February 3, 2007	January 28, 2006
Service cost	$ 33	$ 39	$ 41
Interest cost	30	31	39
Amortization of prior service cost	(14)	(13)	(13)
Amortization of unrecognized prior service cost	(97)	(98)	(90)
Net periodic postretirement benefit cost	$ (48)	$ (41)	$ (23)

The Company s policy is to fund claims as incurred.
Information about the expected cash flows for the postretirement medical plan follows:

Expected Benefit Payments (net of retiree contributions)	Postretirement Medical Plan
2008	$ 40
2009	43
2010	45
2011	45
2012	49
2013 - 2017	288

Clarification of Adoption of SFAS No. 158 with Regard to the Company s Defined Benefit Plans:
In 2006, upon the adoption of SFAS No. 158, the Company recorded the impact of the standard in its entirety in Other Comprehensive Income, an amount after tax of $1.083 million. During 2007, additional guidance was issued as it relates to the adoption of SFAS No. 158, and it clarified that the impact of the initial adoption would not be included in Other Comprehensive Income, but rather would be a direct adjustment to Accumulated Other Comprehensive Income. As a result of this guidance, the Consolidated Statement of Comprehensive Income has been adjusted to show the impact only under previous pension accounting guidance (an amount of approximately $0.086 million).

Litigation. In June 2006, a lawsuit entitled Sarah Ziegler, et al. v. Fred s Discount Store was filed in the United States District Court for the Northern District of Alabama in which the plaintiff alleges that she and other current and former Fred s Discount assistant store managers were improperly classified as exempt executive employees under the Fair Labor Standards Act (FLSA) and seeks to recover overtime pay, liquidated damages, and attorneys fees and court cost. In July 2006, the plaintiffs filed an emergency motion to facilitate notice pursuant to the FLSA that would give current and former assistant manager s information about their rights to opt-in to the lawsuit. After initially denying the motion, in October 2006, the judge granted plaintiffs motion to facilitate notice pursuant to the FLSA. Notice was sent to some 2,055 current and former assistant store managers and approximately 450 persons opted into the case. The cut off date for individuals to advise of their interest in becoming part of this lawsuit was February 2, 2007.

The Company believes that its assistant store managers are and have been properly classified as exempt employees under the FLSA and that the actions described above are not appropriate for collective action treatment. The Company is and will continue to vigorously defend these actions in this matter. Discovery is ongoing and data continues to be reviewed. Following the close of the discovery period in this case, the Company will have an opportunity to seek decertification of the class, and the Company expects to file such a decertification and other motions.

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In addition to the matter described above, the Company is party to other pending legal proceedings and claims arising in the normal course of business. Although the outcome of the proceedings and claims cannot be determined with certainty, management of the Company is of the opinion that it is unlikely that these proceedings and claims will have a material adverse effect on the financial statements as a whole. However, litigation involves an element of uncertainty. There can be no assurance that pending lawsuits will not consume the time and energies of our management or that future developments will not cause these actions or claims, individually or in aggregate, to have a material adverse effect on the financial statements as a whole. We intend to vigorously defend or prosecute each pending lawsuit.

Note 10 Sales Mix

The Company manages its business on the basis of one reportable segment. See Note 1 for a brief description of the Company s business. As of February 2, 2008, all of the Company s operations were located within the United States. The following data is presented in accordance with SFAS 131, Disclosures about Segments of an Enterprise and Related Information.

The Company s sales mix by major category during the last 3 years was as follows:

	For the Year Ended		
	February 2, 2008	**February 3, 2007**	**January 28, 2006**
Pharmaceuticals	32.2%	31.9%	31.3%
Household Goods	24.8%	24.7%	24.8%
Apparel and Linens	9.9%	11.7%	12.7%
Food and Tobacco Products	14.2%	13.0%	12.5%
Health and Beauty Aids	8.0%	8.0%	8.0%
Paper and Cleaning Supplies	8.8%	8.6%	8.5%
Sales to Franchised Fred s Stores	2.1%	2.1%	2.2%
Total Sales Mix	100.0%	100.0%	100.0%

Note 11 QUARTERLY FINANCIAL DATA (UNAUDITED)

The Company s unaudited quarterly financial information for the fiscal years ended February 2, 2008 and February 3, 2007 is reported below:

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Year Ended February 2, 2008	First Quarter 13 weeks	Second Quarter 13 weeks	Third Quarter 13 weeks	Fourth Quarter 13 weeks
Net sales	$442,262	$424,640	$419,913	$494,108
Gross profit	127,001	121,483	124,920	116,839
Net income (loss)	7,438	3,058	4,607	(4,385)
Net income (loss) per share				
Basic	0.19	0.08	0.12	(0.11)
Diluted	0.19	0.08	0.12	(0.11)
Cash dividends paid per share	0.02	0.02	0.02	0.02
Year Ended February 3, 2007	**13 weeks**	**13 weeks**	**13 weeks**	**14 weeks**
Net sales	$416,878	$406,925	$407,872	$535,564
Gross profit	119,844	115,044	119,498	140,533
Net income	7,298	4,323	5,953	9,172
Net income per share				
Basic	0.18	0.11	0.15	0.23
Diluted	0.18	0.11	0.15	0.23
Cash dividends paid per share	0.02	0.02	0.02	0.02

ITEM 9: Changes In and Disagreements with Accountants on Accounting and Financial Disclosure

None.

ITEM 9A. CONTROLS AND PROCEDURES

(a) Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures. As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company s disclosure controls and procedures (as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)). Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer, concluded that, as of the date of their evaluation, the Company s disclosure controls and procedures are effective in timely alerting them to material information required to be included in the Company s periodic SEC reports, subject to the effectiveness of the Company s internal control over financial reporting. Consistent with the suggestion of the Securities and Exchange Commission, the Company has formed a Disclosure Committee consisting of key Company personnel designed to review the accuracy and completeness of all disclosures made by the Company.

(b) Management s Annual Report on Internal Control Over Financial Reporting. The management of Fred s, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a 15(f) under the Securities Exchange Act of 1934. Fred s, Inc. internal control system was designed to provide reasonable assurance to the Company s management and board of directors regarding the fair and reliable preparation and presentation of the Consolidated Financial Statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can

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provide only reasonable assurance with respect to financial statement preparation and presentation.

The management of Fred s, Inc. assessed the effectiveness of the Company s internal control over financial reporting as of February 2, 2008. In making its assessment, the Company used criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control Integrated Framework*. Based on its assessment, management has concluded that the Company s internal control over financial reporting is effective as of February 2, 2008.

Our assessment of the effectiveness of internal control over financial reporting as of February 2, 2008 has been audited by BDO Seidman, LLP, the independent registered public accounting firm who also audited our Consolidated Financial Statements. BDO Seidman s attestation report on our assessment of internal control over financial reporting is included herein.

(c) Attestation Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting.

(d) Changes in Internal Control over Financial Reporting. There have been no changes during the quarter ended February 2, 2008 in the Company s internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders
Fred s Inc.
Memphis, Tennessee

We have audited Fred s Inc. s (the Company s) internal control over financial reporting as of February 2, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying, Item 9A.b Management s Report on Internal Control Over Financial Reporting . Our responsibility is to express an opinion on the Company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of February 2, 2008, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as of February 2, 2008 and February 3, 2007, and the related consolidated statements of income and comprehensive income, changes in shareholders equity, and cash flows for each of the three years in the period ended February 2, 2008 and our report dated April 16, 2008 expressed an unqualified opinion thereon.

BDO Seidman, LLP
Memphis, Tennessee
April 16, 2008

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10: Directors, Executive Officers and Corporate Governance

The following information is furnished with respect to each of the directors and executive officers of the Company:

Name	Age	Positions and Offices
Michael J. Hayes (1)	66	Director, Chairman of the Board, Chief Executive Officer
John R. Eisenman (1)	66	Director
Roger T. Knox (1)	70	Director
John Reier (1)	68	Director, Vice Chairman of the Board
Thomas H. Tashjian(1)	53	Director
B. Mary McNabb (1)	59	Director
Michael T. McMillan (1)	48	Director
Bruce A. Efird	48	President
Jerry A. Shore	55	Executive Vice President and Chief Financial Officer
Dennis K Curtis	48	Executive Vice-President General Merchandise Manager
John A. Casey	61	Executive Vice President Pharmacy Acquisitions
Rick A. Chambers	44	Executive Vice President Pharmacy Operations
Charles S. Vail	65	Corporate Secretary, Senior Vice President Legal Services and General Counsel

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(1) Seven directors, constituting the entire Board of Directors, are to be elected at the 2008 Annual Meeting to serve one year or until their successors are elected.

Michael J. Hayes was elected a director of the Company in January 1987. Mr. Hayes served as Managing Director of the Company from October 1989 until March 2002 when he was elected Chairman of the Board. He has been Chief Executive Officer since October 1989. He was previously employed by Oppenheimer & Company, Inc. in various capacities from 1976 to 1985, including Managing Director and Executive Vice President Corporate Finance and Financial Services.

John R. Eisenman is involved in real estate investment and development with REMAX Island Realty, Inc., located in Hilton Head Island, South Carolina. Mr. Eisenman has been engaged in commercial and industrial real estate brokerage and development since 1983. Previously, he founded and served as President of Sally s, a chain of fast food restaurants from 1976 to 1983, and prior thereto held various management positions in manufacturing and in securities brokerage.

Roger T. Knox is President Emeritus of the Memphis Zoological Society and was its President and Chief Executive Officer from January 1989 through March 2003. Mr. Knox was the President and Chief Operating Officer of Goldsmith s Department Stores, Inc. (a full-line department store in Memphis and Jackson, Tennessee) from 1983 to 1987 and it s Chairman of the Board and Chief Executive Officer from 1987 to 1989. Prior thereto, Mr. Knox was with Foley s Department Stores in Houston, Texas for 20 years. Mr. Knox is also a director of Hancock Fabrics, Inc.

John D. Reier is a Director and Vice Chairman of the Board. On January 4, 2008, Mr. Reier retired from Freds Inc. following the transition to a new Company President, which occurred in September 2007 when Fred s named Bruce A. Efird to that position. Mr. Reier joined the Company in May of 1999 as President and was elected a Director of the Company in August 2000. Prior to joining the company, Mr. Reier was President and Chief Executive Officer of Sunny s Great Outdoors Stores, Inc. from 1997 to 1999, and was President, Chief Operating Officer, Senior Vice President of Merchandising, and General Merchandise Manager at Family Dollar Stores, Inc. from 1987 to 1997.

Thomas H. Tashjian was elected a director of the Company in March 2001. Mr. Tashjian is a private investor. Mr. Tashjian has served as a managing director and consumer group leader at Banc of America Montgomery Securities in San Francisco. Prior to that, Mr. Tashjian held similar positions at First Manhattan Company, Seidler Companies, and Prudential Securities. Mr. Tashjian s earlier retail operating experience was in discount retailing at the Ayr-way Stores, which were acquired by Target, and in the restaurant business at Noble Roman s.

B. Mary McNabb was elected a director of the Company in April 2005. She is currently Chief Executive Officer for Kid s Outlet in California, a position she has held since January 2007. She has served as a member of the Board of Directors of C-ME (Cyber Merchants Exchange), a public company, and now serves as an advisor to the board. McNabb was executive vice president of merchandising and marketing for Factory 2-U from 1989 2001.

Michael T. McMillan was elected a director of the Company in February 2007. He currently serves as Director of Sales Operations for Pepsi-Cola North America, a Division of PepsiCO, where he has spent the last 22 years in various roles including marketing, sales, franchise development, and general management of its bottling operations.

Bruce A. Efird joined the Company in September 2007 as President. Mr. Efird was Executive Vice President-Merchandising for Meijer, Inc., a leading supercenter retailer in the Midwest with more than $13 billion in sales from October 2005 until August 2007. There he was responsible for all merchandising functions, including softlines, home furnishings, drugstore, general merchandise, groceries and perishables. He also was in charge of marketing and advertising functions as well as pricing and e-commerce for the chain s 179 stores across a five-state area. From 1997 until October 2005, Mr. Efird was with Bruno s Supermarkets, Inc. in Birmingham, Alabama, and served as Senior Vice President of Merchandising from 1999 through 2003 and Executive Vice President/General Manager thereafter.

Jerry A. Shore joined the Company in April 2000 as Executive Vice President and Chief Financial Officer. Prior to joining the Company, Mr. Shore was employed by Wang s International, a major importing and wholesale distribution company as Chief Financial Officer from 1989 to 2000, and in various financial management capacities with IPS Corp., and Caterpillar, Inc. from 1975 to 1989.

Dennis K. Curtis was named Executive Vice-President General Merchandise Manager in February 2008. Previously, Mr. Curtis was Executive Vice-President for Store Operations of Freds from July 2003 to January 2008. Prior to this position, Mr. Curtis held the position of Senior Vice-President Divisional Merchandising Manager of Hardlines. Mr. Curtis joined the Company in 1980 as a management trainee in store operations.

John A. Casey was named Executive Vice President Pharmacy Acquisitions in June of 2004 and was previously Executive Vice President Pharmacy Operations of Freds since February 1997. Mr. Casey joined the Company in 1979 and has served in various positions in Pharmacy Operations. Mr. Casey is a registered pharmacist.

Rick A. Chambers was named Executive Vice President Pharmacy Operations in August 2006. Prior to this he held the position of Senior Vice President Pharmacy operations from June 2004 to August 2006. Mr. Chambers joined the Company in July of 1992 and has served in various positions in Pharmacy Operations. Mr. Chambers earned a Doctor of Pharmacy Degree in 1992.

Charles S. Vail has served the Company as General Counsel since 1973, as Corporate Secretary since 1975, and as Senior Vice President Legal since 2006. Mr. Vail joined the Company in 1968.

The remainder of the information required by this item is incorporated herein by reference to the proxy statement for our 2008 Annual Meeting.

ITEM 11: Executive Compensation

Information required by this item is incorporated herein by reference to the proxy statement for our 2008 Annual Meeting.

ITEM 12: Security Ownership of Certain Beneficial Owners and Management

Information required by this item is incorporated herein by reference to the proxy statement for our 2008 Annual Meeting.

ITEM 13: Certain Relationships and Related Transactions and Director Independence

Information required by this item is incorporated herein by reference to the proxy statement for our 2008 Annual Meeting.

ITEM 14. Principal Accounting Fees and Services

Information required by this item is incorporated herein by reference to the proxy statement for our 2008 Annual Meeting.

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PART IV

ITEM 15: Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a)(1) Consolidated Financial Statements (See ITEM 8)
Report of Independent Registered Public Accounting Firm BDO Seidman, LLP.
(a)(2) Financial Statement Schedules
Schedule II Valuation and Qualifying Accounts
(a)(3) Those exhibits required to be filed as Exhibits to this Annual Report on Form 10-K pursuant to Item 601 of Regulation S-K are as follows:

3.1	Certificate of Incorporation, as amended [incorporated herein by reference to Exhibit 3.1 to the registration statement on Form S-8 as filed with the Securities and Exchange Commission (SEC) on March 18, 2003 (SEC File No. 333-103904) (such registration statement, the Form S-8)].
3.2	By-laws, as amended [incorporated herein by reference to Exhibit 3.2 to the Form S-8].
4.1	Specimen Common Stock Certificate [incorporated herein by reference to Exhibit 4.2 to Pre-Effective Amendment No. 3 to the Registration Statement on Form S-1 (SEC File No. 33-45637) (such Registration Statement, the Form S-1)].
4.2	Preferred Share Purchase Plan [incorporated herein by reference to the Company s Report on Form 10-Q for the quarter ended October 31, 1998].
10.1	Form of Fred s, Inc. Franchise Agreement [incorporated herein by reference to Exhibit 10.8 to the Form S-1].
10.2	401(k) Plan dated as of May 13, 1991 [incorporated herein by reference to Exhibit 10.9 to the Form S-1].
10.3	Employee Stock Ownership Plan (ESOP) dated as of January 1, 1987 [incorporated herein by reference to Exhibit 10.10 to the Form S-1].
10.4	Lease Agreement by and between Hogan Motor Leasing, Inc. and Fred s, Inc. dated February 5, 1992 for the lease of truck tractors to Fred s, Inc. and the servicing of those vehicles and other equipment of Fred s, Inc. [incorporated herein by reference to Exhibit 10.15 to Pre-Effective Amendment No. 1 to the Form S-1].
*10.5	1993 Long Term Incentive Plan dated as of January 21, 1993 [incorporated herein by reference to the Company s report on Form 10-Q for the quarter ended July 31, 1993].
***10.6	Term Loan Agreement between Fred s, Inc. and First American National Bank dated as of April 23, 1999 [incorporated herein by reference to the Company s Report on Form 10-Q for the quarter ended May 1, 1999].
***10.7	Prime Vendor Agreement between Fred s Stores of Tennessee, Inc. and Bergen Brunswig Drug Company, dated as of November 24, 1999 [incorporated herein by reference to Company s Report on Form 10-Q for the quarter ended October 31, 1999].
***10.8	

Addendum to Leasing Agreement and Form of Schedules 7 through 8 of Schedule A, by and between Hogan Motor Leasing, Inc. and Fred s, Inc dated September 20, 1999 (modifies the Lease Agreement included as Exhibit 10.4) [incorporated herein by reference to the Company s report on Form 10-K for the year ended January 29, 2000].

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***10.9	Revolving Loan Agreement between Fred s, Inc. and Union Planters Bank, NA and SunTrust Bank dated April 3, 2000 [incorporated herein by reference to the Company s report on Form 10-K for year ended January 29, 2000].
***10.10	Loan modification agreement dated May 26, 2000 (modifies the Revolving Loan Agreement included as Exhibit 10.9) [incorporated herein by reference to the Company s report on Form 10-K for the year ended January 29, 2000].
***10.11	Seasonal Over line Agreement between Fred s, Inc. and Union Planters National Bank dated as of October 11, 2000 [incorporated herein by reference to the Company s Report on Form 10-Q for the quarter ended October 28, 2000].
***10.12	Second Loan modification agreement dated April 30, 2002 (modifies the Revolving Loan and Credit Agreement included as exhibit 10.9). [incorporated herein by reference to the Company s Report on Form 10-Q for the quarter ended August 3, 2002].
10.15	Third loan modification agreement dated July 31, 2003 (modified the Revolving Loan and Credit Agreement dated April 3, 2000.) [incorporated herein by reference to the Company s Report on Form 10-Q for the quarter ended August 2, 2003].
10.16	Fourth modification agreement dated June 28, 2004 modifying the Revolving Loan and Credit Agreement to grant a temporary over line. [incorporated herein by reference to the Company s Report on Form 10-Q for the quarter ended October 30, 2004].
10.17	Fifth modification agreement dated October 19, 2004 modifying the Revolving Loan and Credit Agreement to grant a temporary over line. [incorporated herein by reference to the Company s Report on Form 10-Q for the quarter ended October 30, 2004].
10.18	Sixth Modification Agreement of the Revolving Loan and Credit Agreement dated July 29, 2005 (modifies the Revolving Loan and Credit Agreement dated April 3, 2000.) [incorporated herein by reference to the Company s Report on Form 10-Q for the quarter ended July 30, 2005].
10.19	Lease agreement by and between Banc of America Leasing & Capital, LLC and Fred s Stores of Tennessee, Inc. dated July 26, 2005 for the lease of equipment to Fred s Stores of Tennessee, Inc. [incorporated herein by reference to the Company s Report on Form 10-Q for the quarter ended October 29, 2005].
10.20	Seventh modification agreement dated October 10, 2005 modifying the Revolving Loan and Credit Agreement to grant a temporary over line. [incorporated herein by reference to the Company s report on Form 10-K for the year ended January 28, 2006].
10.21	Eighth modification agreement dated October 30, 2007 modifying the Revolving Loan and Credit Agreement. [incorporated herein by reference to the Company s Report on Form 10-Q for the quarter ended November 3, 2007].
*10.22	Employment agreement, effective as of September 22, 2007, between the Company and Bruce A. Efird. [incorporated herein by reference to the Company s 8-K filed on March 24,

	2008].
**21.1	Subsidiaries of Registrant
**23.1	Consent of BDO Seidman LLP
**31.1	Certification of Chief Executive Officer pursuant to Exchange Rule 13a-14(a) of the Securities Exchange Act.
**31.2	Certification of Chief Financial Officer pursuant to Exchange Rule 13a-14(a) of the Securities Exchange Act.

** 32. Certification of Chief Financial Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350.

(b) **Reports on Form 8-K**

None.

* Management Compensatory Plan

** Filed herewith

*** (SEC File No. under the Securities Exchange Act of 1934 is 00-19288)

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Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Fred s Inc.
Memphis, Tennessee

The audits referred to in our report dated April 16, 2008 relating to the consolidated financial statements of Fred s Inc., which is contained in Item 8 of this Form 10-K also included the audit of the financial statement schedule listed in the accompanying index. This financial statement schedule is the responsibility of the Company s management. Our responsibility is to express an opinion on this financial statement schedule based on our audits.

In our opinion such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

/s/ BDO Seidman, LLP
Memphis, Tennessee
April 16, 2008

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Schedule II Valuation and Qualifying Accounts

Description	Balance at beginning of Period	Additions Charged to Costs and Expenses	Deductions and Reclass Adjustments	Balance at end of Period
Deducted from applicable assets: (in thousands)				
Allowance for doubtful accounts:				
Year ended January 28, 2006	$ 629	$ 193	$ 124	$ 698
Year ended February 3, 2007	$ 698	$ 69	$ 48	$ 719
Year ended February 2, 2008	$ 719	$ 255	$ 95	$ 879
Inventory valuation reserves:				
Year ended January 28, 2006	$	$	$	$
Year ended February 3, 2007	$	$ 2,119	$	$ 2,119
Year ended February 2, 2008	$ 2,119	$ 10,025	$ 2,119	$ 10,025

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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, on this 17th day of April, 2008.

FRED S, INC.

By: /s/ Michael J. Hayes
Michael J. Hayes, Chief
Executive Officer

By: /s/ Jerry A. Shore
Jerry A. Shore, Executive Vice
President and Chief Financial 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 and in the capacities indicated on this 17th day of April, 2008.

Signature	Title
/s/ Michael J. Hayes	Director, Chairman of the Board, Chief Executive Officer (Principal Executive Officer)
Michael J. Hayes	
/s/ Jerry A. Shore	Executive Vice President and Chief Financial
Jerry A. Shore	Officer (Principal Accounting and Financial Officer)
/s/ Roger T. Knox	Director
Roger T. Knox	
/s/ John R. Eisenman	Director
John R. Eisenman	
/s/ John D. Reier	Director and Vice-Chairman of the Board
John D. Reier	
/s/ Thomas H. Tashjian	Director
Thomas H. Tashjian	
/s/ B. Mary McNabb	Director
B. Mary McNabb	

/s/ Michael T. McMillan	Director
Michael T. McMillan	

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