

FRED'S INC
Form 10-Q
September 10, 2009

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

FORM 10-Q

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

For the quarterly period ended August 1, 2009.
OR

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

For the transition period from _____ to _____.

Commission file number 001-14565

FRED'S, INC.
(Exact name of registrant as specified in its charter)

TENNESSEE
(State or Other Jurisdiction of
Incorporation or Organization)

62-0634010
(I.R.S. Employer
Identification Number)

4300 New Getwell Road
Memphis, Tennessee 38118
(Address of Principal Executive Offices)

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

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

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

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

Large accelerated filer ☐

Accelerated filer ☒

Edgar Filing: FREDS INC - Form 10-Q

Non-accelerated filer ☐

Smaller reporting company ☐

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

The registrant had 40,045,831 shares of Class A voting, no par value common stock outstanding as of September 10, 2009.

FRED'S, INC.

INDEX

Page No.

Part I - Financial Information

Item 1 - Financial Statements:

Condensed Consolidated Balance Sheets as of August 1, 2009 (unaudited) and January 31, 2009	3
---	---

Condensed Consolidated Statements of Income for the Thirteen and Twenty-Six Weeks Ended August 1, 2009 (unaudited) and August 2, 2008 (unaudited)	4
---	---

Condensed Consolidated Statements of Cash Flows for the Twenty-Six Weeks Ended August 1, 2009 (unaudited) and August 2, 2008 (unaudited)	5
--	---

Notes to Condensed Consolidated Financial Statements (unaudited)	6-13
--	------

Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations	14-18
--	-------

Item 3 – Quantitative and Qualitative Disclosure about Market Risk	19
--	----

Item 4 – Controls and Procedures	19
----------------------------------	----

Part II - Other Information 19-20

Item 1. Legal Proceedings	19
---------------------------	----

Item 1A. Risk Factors	19
-----------------------	----

Item 4. Submission of Matters to a Vote of Security Holders	20
---	----

Item 6. Exhibits	20
------------------	----

Signatures	20
------------	----

Ex-31.1 Section 302 Certification of the CEO

Ex-31.2 Section 302 Certification of the CFO

Ex-32. Section 906 Certification of the CEO and CFO

Part I – FINANCIAL INFORMATION

Item 1. Financial Statements

FRED'S, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except for number of shares)

	August 1, 2009 (unaudited)	January 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 51,350	\$ 35,128
Receivables, less allowance for doubtful accounts of \$801 and \$885, respectively	28,586	28,857
Inventories	308,918	301,537
Other non-trade receivables	16,098	15,782
Prepaid expenses and other current assets	10,462	11,912
Total current assets	415,414	393,216
Property and equipment, at depreciated cost	138,668	138,036
Equipment under capital leases, less accumulated amortization of \$4,967 and \$4,928 respectively	-	39
Other noncurrent assets, net	15,441	13,484
Total assets	\$ 569,523	\$ 544,775
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 90,291	\$ 69,955
Current portion of indebtedness	261	243
Accrued expenses and other	43,125	45,467
Deferred income taxes	13,557	13,061
Income taxes payable	1,302	8,941
Total current liabilities	148,536	137,667
Long-term portion of indebtedness	4,742	4,866
Deferred income taxes	1,263	1,328
Other noncurrent liabilities	15,937	13,833
Total liabilities	170,478	157,694
Commitments and Contingencies		
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, 40,046,240 and 39,880,836 shares issued and outstanding, respectively	138,052	136,877
Common stock, Class B nonvoting, no par value, 11,500,000 shares authorized, none outstanding	-	-
Retained earnings	259,930	249,141
Accumulated other comprehensive income	1,063	1,063

Edgar Filing: FREDs INC - Form 10-Q

Total shareholders' equity		399,045	387,081
Total liabilities and shareholders' equity	\$	569,523	\$ 544,775

See accompanying notes to condensed consolidated financial statements.

FRED'S, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(unaudited)
(in thousands, except per share amounts)

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	August 1, 2009	August 2, 2008	August 1, 2009	August 2, 2008
Net sales	\$ 434,214	\$ 447,127	\$ 892,594	\$ 911,419
Cost of goods sold	313,472	323,276	642,875	655,087
Gross profit	120,742	123,851	249,719	256,332
Depreciation and amortization	6,489	6,779	12,927	13,862
Selling, general and administrative expenses	106,097	115,126	214,955	228,786
Operating income	8,156	1,946	21,837	13,684
Interest income	(55)	(104)	(78)	(202)
Interest expense	133	181	265	452
Income before income taxes	8,078	1,869	21,650	13,434
Provision for income taxes	3,838	836	8,860	5,151
Net income	\$ 4,240	\$ 1,033	\$ 12,790	\$ 8,283
Net income per share				
Basic	\$ 0.11	\$ 0.03	\$ 0.32	\$ 0.21
Diluted	\$ 0.11	\$ 0.03	\$ 0.32	\$ 0.21
Weighted average shares outstanding				
Basic	39,914	39,794	39,904	39,879
Effect of dilutive stock options	72	26	97	15
Diluted	39,986	39,820	40,001	39,894
Dividends per common share	\$ 0.03	\$ 0.02	\$ 0.05	\$ 0.04
Comprehensive income:				
Net income	\$ 4,240	\$ 1,033	\$ 12,790	\$ 8,283
Other comprehensive income (expense), net of tax postretirement plan adjustment	-	(11)	-	(22)
Comprehensive income	\$ 4,240	\$ 1,022	\$ 12,790	\$ 8,261

See accompanying notes to condensed consolidated financial statements.

FRED'S, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(in thousands)

	For the Twenty-Six Weeks Ended August 1, 2009		August 2, 2008	
Cash flows from operating activities:				
Net income	\$	12,790	\$	8,283
Adjustments to reconcile net income to net cash flows from operating activities:				
Depreciation and amortization		12,927		13,862
Net gain on asset disposition		(19)		(895)
Provision for store closures and asset impairment		-		419
Stock-based compensation		996		1,093
Recovery of uncollectible receivables		(84)		(244)
LIFO reserve increase		591		1,921
Deferred income tax expense		509		3,533
Income tax benefit upon exercise of stock options		26		11
Provision for post retirement medical		-		(22)
(Increase) decrease in operating assets:				
Trade receivables		39		5,110
Inventories		(7,971)		(17,275)
Other assets		1,450		749
Increase (decrease) in operating liabilities:				
Accounts payable and accrued expenses		17,994		22,047
Income taxes payable		84		(11)
Other noncurrent liabilities		(5,722)		750
Net cash provided by operating activities		33,610		39,331
Cash flows from investing activities:				
Capital expenditures		(11,920)		(9,379)
Proceeds from asset dispositions		15		2,286
Insurance recoveries for replacement assets		-		220
Asset acquisition, net (primarily intangibles)		(3,555)		(998)
Net cash used in investing activities		(15,460)		(7,871)
Cash flows from financing activities:				
Payments of indebtedness and capital lease obligations		(105)		(207)
Proceeds from revolving line of credit		-		198,370
Payments on revolving line of credit		-		(229,005)
Excess tax charges from stock-based compensation		(26)		(11)
Proceeds from exercise of stock options and employee stock purchase plan		205		279
Cash dividends paid		(2,002)		(1,597)
Net cash used in financing activities		(1,928)		(32,171)
Increase (decrease) in cash and cash equivalents		16,222		(711)
Cash and cash equivalents:				
Beginning of year		35,128		10,266
End of year	\$	51,350	\$	9,555

Supplemental disclosures of cash flow information:

Interest paid	\$	184	\$	343
Income taxes paid	\$	14,360	\$	500

Non-cash investing and financial activities:

Assets acquired through term loan	\$	-	\$	450
Common stock issued for purchase of capital assets	\$	-	\$	-

See accompanying notes to condensed consolidated financial statements.

FRED'S, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

NOTE 1: BASIS OF PRESENTATION

Fred's, Inc. and subsidiaries ("We", "Our", "Us" or "Company") operates, as of August 1, 2009, 669 discount general merchandise stores, including 24 franchised Fred's stores, in 15 states in the southeastern United States. 291 of the stores have full service pharmacies.

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and are presented in accordance with the requirements of Form 10-Q and therefore do not include all information and notes necessary for a fair presentation of financial position, results of operations and cash flows in conformity with GAAP. The statements do reflect all adjustments (consisting of only normal recurring accruals) which are, in the opinion of management, necessary for a fair presentation of financial position in conformity with GAAP. The statements should be read in conjunction with the Notes to the Consolidated Financial Statements for the fiscal year ended January 31, 2009 incorporated into Our Annual Report on Form 10-K.

The results of operations for the thirteen and twenty-six week periods ended August 1, 2009 are not necessarily indicative of the results to be expected for the full fiscal year.

NOTE 2: 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"). 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 No. FAS ("FSP SFAS") 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 adopted SFAS No. 157 effective February 3, 2008, and its adoption did not have a material effect on its results of operations or financial position. The Company has also evaluated FSP SFAS 157-2 and determined that it will have no impact on its results of operations or financial position. In October 2008, the FASB issued FSP SFAS 157-3, "Determining the Fair Value of a Financial Asset in a Market That Is Not Active". FSP SFAS 157-3 clarifies the application of SFAS No. 157 when the market for a financial asset is inactive. The guidance in FSP SFAS 157-3 is effective immediately and has no effect on our financial statements. In April 2009, the FASB issued FSP SFAS 157-4, "Determining Whether a Market Is Not Active and a Transaction Is Not Distressed" which further clarifies the principles established by SFAS No. 157. The guidance is effective for the periods ending after June 15, 2009 with early adoption permitted for the periods ending after March 15, 2009. The Company has evaluated FSP SFAS 157-4 and determined that it will have no impact on its results of operations or financial position.

In June 2008, the FASB issued FSP EITF 03-6-1, which addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and therefore need to be included in the earnings allocation in computing earnings per share (EPS) under the two-class method described in SFAS No. 128, "Earnings

Per Share". This FSP is effective for fiscal periods beginning after December 15, 2008. The Company adopted FSP EITF 03-6-1 in the quarter ended May 2, 2009 and determined that it had no significant impact on its results of operations or financial position.

In May 2009, the FASB issued SFAS No. 165, "Subsequent Events", which establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. SFAS 165 requires issuers to reflect in their financial statements and disclosures the effects of subsequent events that provide additional evidence about conditions at the balance sheet date. Disclosures should include the nature of the event and either an estimate of its financial effect or a statement that an estimate cannot be made. This standard also requires issuers to disclose the date through which they have evaluated subsequent events and whether the date corresponds with the release of their financial statements. The Company adopted SFAS 165 as of the interim period ended August 1, 2009. The Company has evaluated subsequent events through September 10, 2009, the date it filed this quarterly report on Form 10-Q. As the requirements under SFAS 165 are consistent with its current practice, the implementation of this standard did not have an impact on the Company's consolidated financial statements.

NOTE 3: 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 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 GAAP.

Because the approximation of 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 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 of this estimate in the determination of the cost value of inventory.

The Company calculates 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 \$28.0 million, and \$30.8 million at August 1, 2009 and January 31, 2009 respectively, cost was determined using the retail last-in, first-out (“LIFO”) 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 \$19.7 million at August 1, 2009 and \$19.1 million at January 31, 2009.

The Company has historically included an estimate of inbound freight and certain general and administrative costs in merchandise inventory as prescribed by GAAP. These costs include activities surrounding the procurement and storage of merchandise inventory such as merchandise planning and buying, warehousing, and various administrative functions related to those activities such as accounting, information technology and human resources. The total amount of procurement and storage costs and inbound freight included in merchandise inventory at August 1, 2009 is \$19.2 million, with the corresponding amount of \$19.0 million at January 31, 2009.

NOTE 4: STOCK-BASED COMPENSATION

The Company accounts for its stock-based compensation plans in accordance with Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment" ("SFAS No. 123(R)"). Under SFAS No. 123(R), stock-based compensation expense 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.

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).

A summary of the Company's stock-based compensation (a component of selling and general and administrative expenses) and related income tax benefit is as follows (in thousands):

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 1, 2009	August 2, 2008	August 1, 2009	August 2, 2008
Stock option expense	\$ 280	\$ 278	\$ 540	\$ 649
Restricted stock expense	176	195	350	356
ESPP expense	53	44	106	88
Total stock-based compensation	\$ 509	\$ 517	\$ 996	\$ 1,093
Income tax benefit on stock-based compensation	\$ 101	\$ 111	\$ 216	\$ 226

The fair value of each option granted during the thirteen and twenty-six week periods ended August 1, 2009 and August 2, 2008, respectively, are estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 1, 2009	August 2, 2008	August 1, 2009	August 2, 2008
Stock Options				
Expected volatility	42.6%	40.2%	42.6%	40.3%
Risk-free interest rate	2.6%	3.3%	2.6%	3.4%
Expected option life (in years)	5.84	5.84	5.84	5.84
Expected dividend yield	0.55%	0.49%	0.55%	0.45%
Weighted average fair value at grant date				
	\$ 4.58	\$ 4.82	\$ 4.58	\$ 4.60
Employee Stock Purchase Plan				
Expected volatility	73.5% ¹	37.8%	83.9% ¹	39.4%
Risk-free interest rate	0.1%	3.1%	0.1%	3.1%
Expected option life (in years)	0.5	0.5	0.38	0.38
Expected dividend yield	0.34%	0.34%	0.26%	0.26%
Weighted average fair value at grant date				
	\$ 3.78	\$ 2.44	\$ 3.68	\$ 2.31

1. The increase in expected volatility is due to the fluctuation of the stock price in first and second quarter of 2009 as compared to the same periods last year.

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.

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 29,770 shares issued during the twenty-six weeks ended August 1, 2009. There are 1,410,928 shares approved to be issued under the 2004 Plan and as of August 1, 2009, there were 1,121,093 shares available.

Stock Options

The following table summarizes stock option activity during the twenty-six weeks ended August 1, 2009:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (Thousands)
Outstanding at January 31, 2009	1,138,111	\$ 15.13	3.9	\$ 11
Granted	327,204	\$ 11.06		
Forfeited / Cancelled	(91,753)	\$ 19.42		
Exercised	(600)	-		
Outstanding at August 1, 2009	1,372,962	\$ 13.88	3.7	\$ 1,639
Exercisable at August 1, 2009	669,362	\$ 16.04	2.2	\$ 263

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between Fred’s closing stock price of \$13.48 on the last trading day of the period ended August 1, 2009 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. As of August 1, 2009, total unrecognized stock-based compensation expense net of estimated forfeitures related to non-vested stock options was approximately \$1.6 million, which is expected to be recognized over a weighted average period of approximately 4.1 years. The total fair value of options vested during the twenty-six weeks ended August 1, 2009 was \$350.1 thousand.

Restricted Stock

The following table summarizes restricted stock activity during the twenty-six weeks ended August 1, 2009:

	Number of Shares	Weighted Average Grant Date Fair Value
Non-vested Restricted Stock at January 31, 2009	352,784	\$ 12.39
Granted	19,237	\$ 12.41
Forfeited / Cancelled	(25,791)	\$ 14.34
Vested	(16,803)	\$ 16.68
Non-vested Restricted Stock at August 1, 2009	329,427	\$ 12.02

The aggregate pre-tax intrinsic value of restricted stock outstanding as of August 1, 2009 is \$4.4 million with a weighted average remaining contractual life of 5.7 years. The unrecognized compensation expense net of estimated

forfeitures, related to the outstanding stock is approximately \$2.4 million, which is expected to be recognized over a weighted average period of approximately 5.3 years. The total fair value of restricted stock awards that vested during the twenty-six weeks ended August 1, 2009 was \$281.5 thousand.

NOTE 5: 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 amortized 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 amortized 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. Assets under capital leases are amortized 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. Gains or losses on the sale of assets are recorded as a component of operating income.

The following illustrates the breakdown of the major categories within Property and Equipment:

	August 1, 2009 (unaudited)	January 31, 2009
Property and equipment, at cost:		
Buildings and building improvements	\$ 93,827	\$ 91,826
Leasehold improvements	53,727	49,775
Automobiles and vehicles	5,321	5,223
Airplane	4,697	4,697
Furniture, fixtures and equipment	236,313	230,272
	393,885	381,793
Less: Accumulated depreciation and amortization	(261,740)	(251,002)
	132,145	130,791
Construction in progress	190	912
Land	6,333	6,333
Total Property and equipment, at depreciated cost	\$ 138,668	\$ 138,036

NOTE 6: EXIT AND DISPOSAL ACTIVITIES

During the course of 2008, the Company closed 74 stores and 23 pharmacies. The closures took place during the first three quarters of 2008 pursuant to our restructuring plan announced February 6, 2008 and were 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 underperforming stores the Company would improve its cash flow and operating margin, both of which are core goals of the Company's overall strategic plan. As a result of the successful execution of this plan, the Company is stronger and is in a better position to respond to fluctuations in the economy and to take advantage of opportunities to further improve our business.

During the first half of 2009, the Company did not perform any store closures.

Inventory Impairment

The Company will record a below-cost inventory adjustment to reduce the value of inventory to the lower of cost of market in stores that are planned for closure. The adjustment would be recorded in cost of goods sold in the Condensed Consolidated Statement of Income. There is no outstanding inventory impairment for exit and disposal related activity.

Fixed Asset Impairment

For planned store closures, the Company will record a fixed asset impairment charge for assets identified for disposal. There is no outstanding fixed asset impairment for exit and disposal related activity.

Lease Termination

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.

During fiscal 2007, which ended February 2, 2008, we closed 17 under performing stores and recorded lease contract termination costs of \$1.6 million in rent expense in conjunction with those closings, of which \$1.0 million was utilized during fiscal 2007, leaving \$.6 million in the reserve at the beginning of fiscal 2008.

During fiscal 2008, which ended January 31, 2009, we closed 74 under performing stores and recorded lease contract termination costs of \$10.5 million, of which \$9.6 million was charged to rent expense and \$.9 million reduced the liability for deferred rent. We utilized \$7.6 million during the period, leaving \$3.5 million in the reserve at January 31, 2009.

During the first half of fiscal 2009, we incurred an additional \$0.3 million in rent expense related to the extension of the timeframe expected to terminate the remaining lease agreements of the fiscal 2008 store closures. We also utilized \$1.7 million, leaving \$2.1 million in the reserve at August 1, 2009.

The following table illustrates the exit and disposal activity related to the store closures discussed in the previous paragraphs (in millions):

	Balance at January 31, 2009	Additions FY09	Utilized FY09	Balance at August 1, 2009
Lease contract termination liability	3.5	0.3	1.7	2.1
	\$ 3.5	\$ 0.3	\$ 1.7	\$ 2.1

NOTE 7: ACCUMULATED OTHER 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 GAAP are recorded as an element of shareholders' equity but are excluded from net income. The Company's accumulated other comprehensive income includes the unrecognized prior service costs, transition obligations and actuarial gains/losses associated with our postretirement benefit plan.

The following table illustrates the activity in accumulated other comprehensive income:

	Twenty-Six Weeks Ended August 1, 2009	August 2, 2008	Year Ended January 31, 2009
(in thousands)			

Edgar Filing: FREDS INC - Form 10-Q

Accumulated other comprehensive income	\$	1,063	\$	1,040	\$	1,040
Amortization of postretirement benefit		-		(21)		23
Ending balance	\$	1,063	\$	1,019	\$	1,063

NOTE 8: RELATED PARTY TRANSACTIONS

Atlantic Retail Investors, LLC, which is partially owned by Michael J. Hayes, a director of the Company, owns the land and buildings occupied by twelve FRED'S stores. 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 were \$283.8 thousand and \$675.0 thousand for the thirteen and twenty-six week periods ended August 1, 2009.

Item 2:

Management's Discussion and Analysis of Financial
Condition and Results of Operations

GENERAL

Executive Overview

Recognizing our pharmacy department as a key differentiating factor to other small-box discount retailers, we have accelerated our growth strategy in this area and are aggressively pursuing opportunities to acquire independent pharmacies within our targeted markets. Our emphasis will continue to be on acquisitions and file buys, but cold starts will be employed where it makes sense to do so. As we mentioned last quarter, we began offering our Prescription Plus \$4 generic program to all pharmacies in the chain. We piloted this program on a limited basis last year and found it to be a traffic driver, and thus rolled it out to all pharmacies in the first quarter. We are pleased with this deployment and its effect on our prescription count.

Our Own Brand initiative continues to be a key strategy for the Company in terms of building customer loyalty and increasing gross margin. We have reached an Own Brand penetration rate of 16% of total consumable sales, and that number will continue to grow throughout the year as new Own Brand products are introduced. Our commitment to quality in our Own Brand products is resonating with our customers and they continue to make the switch to our "Fred's Brand". We are continuing to add new products to our Own Brand line on an ongoing basis, with new items in chemicals and food introduced in the second quarter of 2009.

Expense reduction and containment continues to be a key focus of the Company, especially in light of current economic conditions. We are aggressively pursuing cost reductions in all functional areas and are also continuously reviewing internal processes to find efficiencies and/or redundancies and drive unnecessary costs and expenses out of the business. These efforts are being coordinated at the Executive Level and close attention is being paid not to sacrifice service to our customers. These efforts resulted in a 140 basis point reduction in expenses as a percentage of sales in the second quarter of 2009 compared to the same period last year.

Also in the second quarter, we continued the work that we began last year related to our real estate site selection and store layout programs. We continue to improve the interior layout of our stores so that our customers experience more open customer spaces, more logical product flow and a more consistent and meaningful price message, all of which are intended to provide a more pleasurable shopping trip. We also continue to hone our real estate strategy so that the proper site is selected to support our targeted demographics, thus driving traffic and sales. Many of these efforts will culminate in the third quarter with the grand opening of our "Pilot Store of the Future".

Over the remainder of 2009, we intend to continue with capital improvements in infrastructure, including new stores as well as existing store expansion 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, in-store systems, and pharmacy systems.

As previously reported, the Company expects total earnings per diluted share for 2009 to be in the range of \$0.73 to \$0.80. These earnings projections include the following significant events affecting the balance of the year:

- The third year incremental raising of the federal minimum wage which will negatively impact our labor expense by approximately \$2.3 million.
- The continued product mix shift to basic and consumable items, coupled with intense pharmacy competition, will continue to negatively affect gross margin.

- The positive margin impact of our Own Brand initiatives as mentioned in previous paragraphs.

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, managing the effects of inflation or deflation, controlling product mix, increasing operating margin through improved gross margin and leveraging operating costs, and generating adequate cash flow to fund the Company's future needs.

Other factors that will affect Company performance in 2009 include the continuing management of the impacts of the changing regulatory environment in which our pharmacy department operates. Additionally, we believe that the ongoing recession and elevated unemployment rate continue to place tremendous economic pressure on the consumer. However, we also continue to believe that our affordable pricing and value proposition make us an attractive destination to wary consumers.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Company's discussion and analysis of its financial condition and results of operations are based upon the Company's condensed financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The critical accounting matters that are particularly important to the portrayal of the Company's financial condition and results of operations and require some of management's most difficult, subjective and complex judgments are described in detail in the Company's Annual Report on Form 10-K for the fiscal year ended January 31, 2009. The preparation of condensed financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, the Company evaluates its estimates, including those related to inventories, income taxes, insurance reserves, contingencies and litigation. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

RESULTS OF OPERATIONS

THIRTEEN WEEKS ENDED AUGUST 1, 2009 AND AUGUST 2, 2008

Sales

Net sales for the second quarter of 2009 decreased to \$434.2 million from \$447.1 million in 2008, a quarter-over-quarter decline of \$12.9 million or 2.9%, reflecting the Company's store closing program coupled with the ongoing economic challenges impacting our customers' disposable income. Excluding sales from stores closed in 2008 (\$12.0 million), total sales were down \$0.9 million over the second quarter last year. On a comparable store basis, sales in the second quarter declined 1.3% (\$5.3 million) compared with a 4.9% (\$19.6 million) increase in the same period last year.

The Company's 2009 front store (non-pharmacy) sales decreased 5.8% over 2008 front store sales. Excluding the front store sales from stores closed in 2008 (\$12.0 million), sales decreased 1.75% over the second quarter last year. Although front store sales growth declined in the quarter in categories such as home furnishings, men's clothing, health and beauty aids and toys, we did experience sales increases in the more discretionary consumable categories such as tobacco, direct beverages, paper and cleaning supplies and pets.

The Company's pharmacy sales were 32.8% of total sales in the second quarter of 2009 compared to 30.7% of total sales in the same quarter last year 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 which we closed during the first quarter of 2009, increased 3.6% over 2008, with third party prescription sales representing approximately 93% of total pharmacy sales, the same as in the prior year. The Company's pharmacy department continues to benefit from an ongoing program of purchasing prescription files from independent pharmacies as well as the addition of pharmacy departments in existing store locations.

Sales to FRED'S 24 franchised locations during the second quarter of 2009 decreased to \$9.2 million (2.1% of sales) from \$9.7 million (2.2% of sales) in 2008. The decrease in quarter over quarter franchise sales resulted from the ongoing economic challenges impacting our customers' disposable income. The Company does not intend to expand its franchise network in the future.

The sales mix for the period was 32.8% Pharmaceuticals, 23.6% Household Goods, 16.7% Food and Tobacco, 9.5% Paper and Cleaning Supplies, 7.8% Apparel and Linens, 7.5% Health and Beauty Aids, and 2.1% Franchise. The sales mix for the same period last year was 30.7% Pharmaceuticals, 25.5% Household Goods, 15.3% Food and Tobacco, 9.3% Paper and Cleaning Supplies, 9.1% Apparel and Linens, 7.9% Health and Beauty Aids, and 2.2% Franchise.

For the quarter, comparable store customer traffic decreased 0.4% over the same quarter last year while the average customer ticket decreased 0.9% to \$18.68.

Gross Margin

Gross margin for the second quarter of 2009 decreased to \$120.7 million from \$123.9 million in 2008, a quarter-over-quarter decline of 2.5%. Gross margin, measured as a percentage of sales, increased slightly to 27.8% from 27.7% in the same quarter last year. The overall improvement in gross margin percentage results primarily from an increase in vendor consideration, better management of inventory resulting in fewer clearance markdowns and lower freight costs.

Selling, General and Administrative Expenses

Selling, general and administrative expenses, including depreciation and amortization, decreased to \$112.6 million in 2009 (25.9% of sales) from \$121.9 million in 2008 (27.3% of sales). This 140 basis point expense leverage resulted primarily from the effect of our store closures in fiscal 2008 (\$7.3 million), lowering distribution costs (\$1.5 million) and managing costs in our stores by increasing labor efficiencies (\$0.5 million).

Operating Income

Operating income increased to \$8.2 million in the second quarter of 2009 (1.9% of sales) from \$1.9 million in 2008 (0.4% of sales) due primarily to a reduction in selling, general and administrative expenses as the Company did not incur expenses related to store closures in the current fiscal quarter, as well as continued focus on managing costs in our stores, as described in the Selling, General and Administrative Expenses section above. This favorability in expenses was partially offset by a decrease in gross margin of \$3.2 million (2.5% of sales), as described in the Gross Margin section above.

Interest Expense

The Company incurred net interest expense of \$0.1 million in the second quarter of 2009 and 2008.

Income Taxes

For the second quarter of 2009, the effective income tax rate was 47.5%, as compared to 44.7% in the second quarter of 2008. The increase in the effective tax rate during the second quarter of 2009 was primarily due to the final assessment and settlement of the Internal Revenue Service exam for tax years 2004 - 2007.

Net Income

As a result of the fluctuations described in the preceding sections, net income increased 310.5% to \$4.2 million (or \$.11 per diluted share) in the second quarter of 2009 from \$1.0 million (or \$.03 per diluted share) during the same period last year. While net sales decreased by 2.9% and gross margin decreased 2.5% over the same period last year, the improvement in selling, general and administrative expenses (7.6%) more than offset this unfavorability.

TWENTY-SIX WEEKS ENDED AUGUST 1, 2009 AND AUGUST 2, 2008

Sales

Net sales decreased to \$892.6 million in 2009 from \$911.4 million in 2008, a year-over-year decline of \$18.8 million or 2.1%, reflecting the Company's store closing program coupled with the ongoing economic challenges impacting our customers' disposable income. Excluding sales from stores closed in 2008 (\$37.7 million), total sales increased 2.2% (\$18.9 million) over last year. This increase was attributable to an increase in comparable store sales of .8% (\$6.5 million) and increase in non-comparable store sales of 1.4% (\$12.4 million).

The Company's 2009 front store (non-pharmacy) sales decreased 4.7% over 2008 front store sales. Excluding the front store sales from stores closed in 2008 (\$37.7 million), sales increased 1.6% over last year. Although front store sales growth declined in the quarter in the more discretionary categories such as home furnishings, health and beauty aids, men's clothing and footwear, we did experience sales increases in consumable categories such as tobacco, pets, direct beverages, food and prepaid products.

The Company's pharmacy sales were 33.1% of total sales in the first half of 2009 compared to 31.2% of total sales in the same period last year 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, which we closed during the first quarter of 2009, increased 3.6% over 2008, with third party prescription sales representing approximately 93% of total pharmacy sales, the same as in the prior year. The Company's pharmacy department continues to benefit from an ongoing program of purchasing prescription files from independent pharmacies as well as the addition of pharmacy departments in existing store locations.

Sales to FRED'S 24 franchised locations during the first half of 2009 decreased to \$19.4 million (2.2% of sales) from \$20.0 million (2.2% of sales) in 2008. The decrease in year-over-year franchise sales were a result of the ongoing economic challenges impacting our customers' disposable income.

The sales mix for the period was 33.1% Pharmaceuticals, 23.5% Household Goods, 16.4% Food and Tobacco, 9.3% Paper and Cleaning Supplies, 7.8% Apparel and Linens, 7.7% Health and Beauty Aids, and 2.2% Franchise. The sales mix for the same period last year was 31.3% Pharmaceuticals, 24.9% Household Goods, 15.4% Food and Tobacco, 8.9% Apparel and Linens, 9.2% Paper and Cleaning Supplies, 8.1% Health and Beauty Aids, and 2.2% Franchise.

For the year, comparable store customer traffic increased 0.6% over the same period last year while the average customer ticket increased 0.2% to \$19.05.

Gross Margin

Gross margin for the first half of 2009 decreased to \$249.7 million from \$256.3 million in 2008, a year-over-year decline of 2.6%. Gross margin, measured as a percentage of sales, declined to 28.0% from 28.1% last year. Gross margin was unfavorably impacted by continued competitive pressures, an unfavorable shift in the product mix toward lower margin basic and consumable products while being favorably impacted by an increase in vendor dollar consideration.

Selling, General and Administrative Expenses

Selling, general and administrative expenses, including depreciation and amortization, decreased to \$227.9 million in 2009 (25.5% of sales) from \$242.6 million in 2008 (26.6% of sales). This 110 basis point expense leverage resulted primarily from the effect of our store closures in fiscal 2008 (\$7.9 million), lowering distribution costs (\$3.4 million) and managing costs in our stores by increasing labor efficiencies (\$2.3 million).

Operating Income

Operating income increased 59.6% to \$21.8 million in the first half of 2009 (2.4% of sales) from \$13.7 million in 2008 (1.5% of sales) due primarily to a reduction in selling, general and administrative expenses as the Company did not incur expenses related to store closures in the first half of this year as well as continued focus on managing costs in our stores and distribution centers, as described in the Selling, General and Administrative Expenses section above. This favorability in expenses was partially offset by a decrease in gross margin of \$6.6 million, a year-over-year decline of 2.6%, as described in the Gross Margin section above.

Interest Expense

The Company incurred net interest expense of \$0.2 million in the first half of 2009 and 2008.

Income Taxes

For the first half of 2009, the effective income tax rate was 40.9%, as compared to 38.3% for the same period last year. The increase in the effective tax rate was primarily due to the final assessment and settlement in the second quarter of the Internal Revenue Service exam for tax years 2004 – 2007. We anticipate the tax rate for the remaining two quarters to be in the range of 35% to 37%.

Net Income

As a result of the fluctuations described in the preceding sections, net income increased 54.4% to \$12.8 million (or \$.32 per diluted share) in the first half of 2009 from \$8.3 million (or \$.21 per diluted share) during the same period last year. While net sales decreased by 2.1% and gross margin decreased 2.6% over the same period last year, the improvement in selling, general and administrative expenses (6.1%) more than offset this unfavorability.

LIQUIDITY AND CAPITAL RESOURCES

Due to the seasonality of our business and the continued increase in the number of stores and pharmacies, inventories are generally lower at year-end than at each quarter-end of the following year.

Cash provided by operating activities totaled \$33.6 million during the twenty-six week period ended August 1, 2009 compared to \$39.3 million in the same period of the prior year. While cash was used for the purchase of inventories, we generated operating cash flow through quarterly income and from our ongoing initiative to better manage our Accounts Payable processes.

Cash used in investing activities totaled \$15.5 million, and consisted primarily of expenditures related to existing stores (\$9.0 million), pharmacy acquisitions (\$3.6 million), capital expenditures associated with the store and pharmacy expansion program (\$1.0 million) and technology and other corporate expenditures (\$1.9 million). During the first six months of 2009, we opened 6 stores and 7 pharmacies and closed 3 pharmacies. The Company anticipates that in the remainder of 2009 it will open 10 to 14 stores and 5 to 10 pharmacies. In 2009, the Company is planning capital expenditures totaling approximately \$21.4 million. Expenditures are planned totaling approximately \$13.5 million for upgrades, remodels, or new stores and pharmacies; \$3.9 million for technology upgrades, \$2.4 million for distribution center equipment and capital replacements and \$1.6 million for other corporate expenditures. In addition, the Company also plans expenditures of \$5.0 million for the acquisition of customer lists and other pharmacy related items. Depreciation expense for 2009 will be approximately \$26.0 million.

Cash used by financing activities totaled \$1.9 million and included \$2.0 million for the payment of cash dividends and was offset by \$0.2 million in proceeds from the exercise of stock options and employee stock purchase plan. There were \$5.0 million in borrowings outstanding at August 1, 2009 related to real estate mortgages compared to \$5.1 million at January 31, 2009.

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

FORWARD-LOOKING STATEMENTS

Other than statements based on historical facts, many of the matters discussed in this Form 10-Q 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. Sections 77z-2 and 78u-5. The Reform Act created a safe harbor to protect companies from securities law liability in connection with forward-looking statements. We intend to qualify both our 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", "will likely 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 that 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.
- Potential adverse results in the Fair Labor Standards Act (“FSLA”) litigation described under Legal Proceedings on page 20.
- Other factors affecting business beyond our control, including (but not limited to) those discussed under Part 1, ITEM 1A “Risk Factors” of the Company’s Annual Report on Form 10-K for the fiscal year ended January 31, 2009.

Consequently, all forward-looking statements are qualified by this cautionary statement. Readers should not place undue reliance on any forward-looking statements. We undertake no obligation to update any forward-looking statement to reflect events or circumstances arising after the date on which it was made.

Item 3.

QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We have no holdings of derivative financial or commodity instruments as of August 1, 2009. We are exposed to financial market risks, including changes in interest rates. All borrowings under our 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 our income. All of our business is transacted in U.S. dollars and, accordingly, foreign exchange rate fluctuations have not had a significant impact on us, and they are not expected to in the foreseeable future.

Item 4.

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 and Exchange Act of 1934, as amended (the "Exchange Act")). Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Act (15 U.S.C. 78 et seq.) is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Additionally, they concluded that our disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that the Company is required to file or submit under the Exchange Act is accumulated and communicated to management, including the Chief Executive Officer and the Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures.

(b) Changes in Internal Control over Financial Reporting. There have been no changes during the quarter ended August 1, 2009 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.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In July 2008, a lawsuit styled Jessica Chapman, on behalf of herself and others similarly situated, v. FRED'S Stores of Tennessee, Inc. was filed in the United States District Court for the Northern District of Alabama, Southern Division, in which the plaintiff alleges that she and other female assistant store managers are paid less than comparable males and seeks compensable damages, liquidated damages, attorney fees and court costs. The plaintiff filed a motion seeking collective action. Briefs have been filed and oral arguments have been conducted, but the court has not yet ruled. The Company believes that all assistant managers have been properly paid and that the matter is not appropriate for collective action treatment. Discovery has not yet begun. The Company is and will continue to vigorously defend this matter. In accordance with SFAS No. 5, "Accounting for Contingencies", the Company does not feel that a loss in this matter is probable or reasonably estimated. Therefore, we have not recorded a liability for this case.

In addition to the matters disclosed above, the Company is party to several 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 energy 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 1A. Risk Factors

The risk factors listed in Part I, “Item 1A. Risk Factors” in the Annual Report on Form 10-K for the fiscal year ended January 31, 2009, should be considered with the information provided elsewhere in this Quarterly Report on Form 10-Q, which could materially adversely affect the business, financial condition or results of operations. There have been no material changes to the risk factors as previously disclosed in such Annual Report on Form 10-K.

Item 4. Submission of Matters to a Vote of Security Holders

The Annual Meeting of the Shareholders of Fred's, Inc. was held on June 17, 2009. Three proposals were presented to the shareholders for a vote. Bruce Efird, Michael J. Hayes, John R. Eisenman, Roger T. Knox, Thomas H. Tashjian, B. Mary McNabb and Michael T. McMillan were elected as directors of the Company. The shareholders also ratified the appointment of BDO Seidman, LLP as our registered public accounting firm for the fiscal year ending January 30, 2010. The shareholders also approved a non-binding proposal presented by shareholder CalPERS recommending that the Company adopt majority voting for the election of directors.

The results of the voting were as follows:

	For	Abstain / Against	Withheld	Broker Non- Vote
Election of Directors:				
Michael J. Hayes	15,506,843		22,517,939	2,011,778
John R. Eisenman	15,362,184		22,662,599	2,011,778
Roger T. Knox	15,359,840		22,664,943	2,011,778
Thomas H. Tashjian	16,878,237		21,146,546	2,011,778
B. Mary McNabb	15,367,508		22,657,275	2,011,778
Michael T. McMillan	15,364,742		22,660,041	2,011,778
Bruce A. Efird	17,232,028		20,792,755	2,011,778
Appointment of BDO Seidman, LLC	37,937,192	37,507	19,312	
Shareholder Proposal	26,986,824	8,238,309	50,538	

Item 6. Exhibits

Exhibits:

- 31.1 Certification of Chief Executive Officer.
- 31.2 Certification of Chief Financial Officer.
- 32 Certification of Chief Executive Officer and Chief Financial Officer pursuant to rule 13a-14(b) under the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FRED'S, INC.

Date: September 10, 2009

/s/ Bruce A. Efird
Bruce A. Efird
Chief Executive Officer and President

Date: September 10, 2009

/s/ Jerry A. Shore
Jerry A. Shore
Chief Financial Officer

