FREDS INC
Form 10-K
April 14, 2011
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 January 29, 2011

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	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:

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

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 ¨ 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 ¨ 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 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 ¨

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K
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 ¨	Accelerated filer þ	Non-accelerated filer ¨	Smaller reporting company ¨
	(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 ¨ 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 July 31, 2010 the last business day of the registrant’s most recently completed second fiscal quarter, was approximately $427 million. Shares of voting stock held by executive officers, directors and holders of more than 10% of the outstanding voting shares have been excluded from this calculation because such persons may be deemed to be affiliates. Exclusion of such shares should not be construed to indicate that any of such persons possess the power, direct or indirect, to control the Registrant, or that such person is controlled by or under common control of the Registrant.

As of April 12, 2011, there were 39,299,233 shares outstanding of the Registrant’s Class A no par value voting common stock.
As of April 12, 2011, 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 2011 annual shareholders meeting, to be filed within 120 days of the registrant’s fiscal year end, are incorporated into Part III of this Annual Report on Form 10-K 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”, “will likel continue” and variations of such words 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 effect buying patterns of our customers and supply chain efficiency;
- Changes in consumer spending and our ability to anticipate buying patterns and anticipate and implement appropriate inventory strategies;
- Continued availability of capital and financing;
- Competitive factors;
- Changes in reimbursement factors 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 I, 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 653 (as of January 29, 2011) 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 82% of FRED'S stores are in markets with populations of 15,000 or fewer people). Full service pharmacies are included in 313 of the Company's stores (as of January 29, 2011). 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 availability of products at everyday low prices and regularly advertised departmental promotions and seasonal specials. FRED'S stores have average selling space of 14,319 square feet and had average sales of $2,760,000 in fiscal 2010. No single store accounted for more than 1.0% of net sales during fiscal 2010.

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, surprise and delight items, 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 43% 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 a customer-centric store layout and fast checkouts. By offering general merchandise and refrigerated foods together with pharmacies in many of our stores, we provide a full selection of merchandise to our customer.

Expansion Strategy

In 2011, the Company plans a moderate expansion approach and intends to open approximately 20 - 25 stores and 10 – 15 pharmacies and close an estimated 10 stores and 5 pharmacies.

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. As part of the Company's continuing operations, we perform research to discover potential underperforming stores. The Company uses such research and analysis to identify potential store closures.

FRED'S opened 15 stores and closed 7 stores in 2010. The majority of new stores opened in 2010 were located in Mississippi and Alabama. The Company's new store prototype normally has 16,000 square feet of space. The Company prefers to use developers to construct build-to-suit locations with leases beginning after completion. In certain cases, the Company leases second generation locations that may alter the size and layout of our typical build-to-suit store. Opening a new store currently costs between $450,000 and $600,000 for inventory, furniture, fixtures, equipment and leasehold improvements.

In 2010, the Company added 21 new pharmacies and closed 15 pharmacies. Approximately 48% of FRED'S stores as of January 29, 2011 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 become an employee of FRED'S, thereby providing continuity in the pharmacist-patient relationship.

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

	2010	2009	2008	2007	2006
Stores open at beginning of period	645	639	692	677	621
Store opened/acquired during period	15	15	21	35	59
Stores closed during period	(7)	(9)	(74)	(20)	(3)
Stores open at end of period	653	645	639	692	677
Number of stores with pharmacies at end of period	313	307	284	296	289
Square feet of selling space at end of period (in thousands)	9,350	9,360	9,323	10,215	9,946
Average square feet of selling space per store	14,319	14,411	14,590	15,239	15,290
Franchise stores at end of period	24	24	24	24	24

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 targeted 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 30 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 2010, 2009 and 2008 were 3.8%, 3.0% and 2.3%, respectively, and gross profit, as a percentage of total gross profit for the same time period was 3.5%, 2.8% and 2.1%, 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 companies in the nation have stores in areas in which the Company operates. Management believes that its knowledge of regional and local consumer preferences, developed over its 64 year history, enables the Company to compete very effectively within its region.

Management believes that FRED'S has a distinctive niche in that it offers a wider variety of merchandise with 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 offered in our high-traffic departments, such as health and beauty aids and paper and cleaning supplies, are comparable to those of larger discount retailers. The depth and variety in these departments is a promise of our "We Got It" program, which ensures that we have our highest demand consumable items (700 – 800 items) on our shelves and available to our customers.

Purchasing

The Company’s primary buying activities (other than prescription drug buying) are directed from the corporate office by two Executive Vice Presidents and General Merchandise Managers through five Divisional Senior Vice Presidents of Merchandising. The Merchandising Department is supported by a staff of 31 merchants and assistants. The merchants are participants in an incentive compensation program, which is based upon various factors primarily relating to gross margin return on inventory, all of which are intended to drive shareholder value. 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 5.0% in 2010, 5.8% in 2009 and 6.2% in 2008 of the Company’s total purchases from Procter and Gamble, our largest general merchandise vendor. The Company believes that adequate alternative sources of products are available for these categories of merchandise.

During 2010, 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 2010, 2009 and 2008 approximately 38%, 38% and 37%, 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, which continues through 2012. 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 Procter and Gamble mentioned previously, no other supplier accounted for more than 5% of the Company’s total purchases for the years 2010, 2009 and 2008.

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:

	For the Year Ended					
	January 29, 2011		January 30, 2010		January 31, 2009	
Pharmaceuticals	34.1	%	33.5	%	31.7	%
Household Goods	24.1	%	23.4	%	24.8	%
Food and Tobacco Products	16.2	%	16.2	%	15.5	%
Paper and Cleaning Supplies	8.6	%	9.2	%	9.2	%
Apparel and Linens	7.6	%	7.9	%	8.6	%
Health and Beauty Aids	7.4	%	7.6	%	8.0	%
Sales to Franchised Fred's Stores	2.0	%	2.2	%	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 2010, the average customer transaction size for comparable stores was approximately $19.75, and the number of customer transactions totaled approximately 90 million. The average transaction size was approximately $19.29 in 2009 and $19.05 in 2008.

Our FRED'S Brand products include household cleaning supplies, health and beauty aids, disposable diapers, pet foods, paper products and a variety of food and beverage products. Private label products sold constituted approximately 9.0% of total store sales in 2010 compared to 8.2% in 2009 and 5.9% in 2008. 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 2010 strategic plan, we expanded our private label program and plan to continue that expansion in 2011. 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 $37.4 million in 2010, $38.4 million in 2009 and $39.6 million in 2008. Franchise and other fees earned totaled approximately $2.0 million in 2010, $2.1 million in 2009 and $2.1 million in 2008. 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.

Advertising and Promotions

Net advertising and promotion costs represented approximately 1.2% of net sales in 2010, 2009 and 2008. The Company uses direct mail, television, radio and select newspaper advertising to deliver the FRED'S value message. The Company utilizes full-color circulars coordinated by our internal advertising staff to promote its merchandise, special promotional events and a discount retail image. In 2010, we expanded our marketing to include email and social media. 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 merchants have discretion to mark down slow moving items. The Company offers regular clearance 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 Operations

All FRED'S stores are open six days a week (Monday through Saturday), and most stores are open seven days a week (excluding the pharmacy). Store hours are generally from 9:00 a.m. to 9:00 p.m.; however, certain stores are only open 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 38 district managers and five Regional Vice Presidents supervise the management and operation of FRED'S stores.

FRED'S operates 313 pharmacies (as of January 29, 2011), which offer brand name and generic pharmaceuticals and are staffed by licensed pharmacists and are managed by 11 healthcare managers. 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 44 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

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. Additionally, the company uses NEX/DEX technology for in-store receiving and inventory control for all items delivered directly to our stores. The Company conducts annual physical inventory counts at all FRED'S stores and has implemented the use of radio frequency devices (RF guns) to conduct cycle counts to ensure replenishment accuracy.

Distribution

The Company has an 850,000 square foot distribution center in Memphis, Tennessee that services 366 stores and a 600,000 square foot distribution center in Dublin, Georgia that services 287 stores (see “Properties” below). Approximately 45% of the merchandise received by FRED’S stores in 2010 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 throughout the year to ensure accuracy within the Warehouse Management System.

Seasonality

Our business is somewhat seasonal in that the Company’s sales volume is heavier around the first 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 first 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.

The following table reflects the seasonality of net sales, gross profit, operating income, and net income by quarter.

For the year ended:	1st Quarter		2nd Quarter		3rd Quarter		4th Quarter	
January 29, 2011								
Net Sales	25.6	%	24.4	%	23.6	%	26.4	%
Gross Profit	26.0	%	23.9	%	24.6	%	25.5	%
Operating Profit	28.2	%	17.6	%	25.0	%	29.2	%
Net Income	27.7	%	16.8	%	26.4	%	29.1	%
January 30, 2010								
Net Sales	25.6	%	24.3	%	23.6	%	26.5	%
Gross Profit	25.8	%	24.2	%	24.6	%	25.4	%
Operating Profit	35.5	%	21.2	%	19.9	%	23.4	%
Net Income	36.2	%	18.0	%	21.3	%	24.5	%
January 31, 2009								
Net Sales	25.8	%	24.9	%	23.2	%	26.1	%
Gross Profit	26.3	%	24.6	%	24.7	%	24.4	%
Operating Profit *	44.6	%	7.4	%	35.7	%	12.3	%
Net Income *	43.6	%	6.2	%	36.6	%	13.6	%

* Results include certain charges for the non-routine closings of 75 stores in 2008 (see Item 7 "Exit and Disposal Activities" section) and implementation of ASC 740, primarily in the second quarter of 2008.

Employees

At January 29, 2011, the Company had approximately 4,873 full-time and 4,979 part-time employees, the majority of which are 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 a union, UNITE-HERE, pursuant to a three (3) year collective bargaining agreement which went into effect on July 1, 2008. 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 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. 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 “Item 1A - 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 Securities and Exchange Commission (SEC), as well as the Sarbanes-Oxley Act of 2002. These laws and regulations impose significant 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. Additionally, the Drug Enforcement Agency ("DEA") requires that controlled substances be monitored and controlled at all times.

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 changes to various state and federal insurance laws and regulations in connection with the Company's pharmacy operations.

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 recently enacted Patient Protection and Affordable Care Act of 2010 may affect our pharmacy business, but it is too early to judge what that impact might be. The Company is unable to predict accurately whether or when additional 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 2010, 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 website, 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 with or furnished to the SEC.

ITEM 1A. Risk Factors

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.

Our business is somewhat seasonal.

We typically realize a significant portion of our net sales during the Christmas selling season in the fourth quarter. Our inventories and short-term borrowings, if required, increase in anticipation of this holiday season. A seasonal merchandise inventory imbalance could result if for any reason our 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, our profitability and operating results could be adversely affected by unanticipated markdowns, especially in seasonal merchandise.

We operate in a competitive industry.

We are in a highly competitive sector of the discount retail industry. This competitive environment subjects us to the risk of reduced profitability because of lower prices, and lower margins, required to maintain our competitive position. We compete with discount stores and with many other retailers, including department stores, variety stores, dollar stores, discount clothing stores, drug stores, grocery stores, outlet stores, convenience stores, warehouse stores and other stores, some of whom may have greater resources than we do. This competitive environment subjects us to various risks, including the ability to continue to provide competitively priced merchandise to our customers that will allow us to maintain profitability and continue store growth. Some of our competitors utilize aggressive promotional activities, advertising programs, and pricing discounts and our results of operations could be adversely affected if we do not respond effectively to these efforts.

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

A significant portion of our sales are funded by federal and state governments and private insurance plans. For the years ended January 29, 2011 and January 30, 2010, pharmaceutical sales were 34.1% and 33.5% of total sales, respectively. 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, and in light of a worsening economy and recent healthcare legislation, 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 our 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 our business by reducing consumer spending or causing consumers to shift their spending to other products. We might be unable to anticipate these buying patterns and implement appropriate inventory strategies, which would adversely affect our sales and gross profit performance. In addition, increases in fuel and energy costs would increase our transportation costs and overall cost of doing business and could adversely affect our 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 our net sales. In addition, these disruptions could also adversely affect our supply chain efficiency and make it more difficult for us to obtain sufficient quantities of merchandise from suppliers. A number of our stores are located in areas that are susceptible to hurricanes and tornadoes.

A significant disruption in our computer systems could adversely affect our business.

We rely extensively on our computer systems to manage inventory, process customer transactions and record results. Our systems are subject to damage or interruption from power outages, telecommunications failures, computer viruses, security breaches and natural disasters. If our systems are damaged or fail to function properly, we may incur substantial costs to repair or replace them, and may experience loss of critical data and interruptions or delays in our ability to manage inventories or process customer transactions, which could adversely affect our results of operations.

If we fail to protect the security of personal information about our customer, we could be subject to costly government enforcement actions or private litigation and our reputation could suffer.

The nature of our business involves the receipt of personal information about our customers. If we experience a data security breach, we could be exposed to government enforcement actions and private litigation. In addition, our customers could lose confidence in our ability to protect their personal information, which could cause them to discontinue usage of credit cards in our stores, decline to use our pharmacy services, or stop shopping at our stores altogether. Such events could lead to lost future sales and adversely affect our results of operations.

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

We have maintained good relations with our vendors and believe that we are generally able to obtain attractive pricing and other terms from vendors. We purchase a significant portion of our inventory from foreign suppliers, principally in China. 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 duties on imports could cause significant delays or interruptions in the supply of our merchandise or increase our costs. Also, our cost of goods is affected by the fluctuation of local currencies against the dollar in countries where these goods are produced. 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. We purchase a significant amount of goods from Procter and Gamble and several large import vendors and any disruption in that supply and or pricing of such merchandise could negatively impact our operations and results.

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

We maintain two distribution facilities in our geographic territory, and plan on constructing new facilities as needed to support our growth. One of our key business strategies is to expand our base of retail stores. We plan on expanding and refreshing our network of stores through new store openings and remodeling existing stores each year. Delays in opening, refreshing or remodeling stores or delays in opening distribution facilities to service those new stores could adversely affect our future operations by slowing growth, which may in turn reduce revenue and margin 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 us.

Operational difficulties could disrupt our business.

Our stores are managed through a network of geographically dispersed management personnel. Our inability to effectively and efficiently operate our stores, including the ability to control losses resulting from inventory shrinkage, may negatively impact our sales and/or margin. In addition, we rely upon our 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. Our operation depends on a variety of information technology systems for the efficient functioning of its business. We rely on certain software vendors to maintain and upgrade these systems as needed. We rely on telecommunications carriers to gather and disseminate our operations information. The disruption or failure of these systems or carriers could negatively impact our operations.

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

We have 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 our operations.

Higher than expected costs and not achieving our targeted results associated with the implementation of new programs, systems and technology could adversely affect our business.

We are undertaking a variety of operating initiatives as well as store upgrades and infrastructure initiatives. The failure to properly execute any of these initiatives could have an adverse impact on our future operating results.

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 our ability to achieve our financial targets. Changes in trade restrictions, new tariffs and quotas, and higher shipping costs for goods could also adversely impact our ability to achieve anticipated operating results.

We depend on the success of our new store opening program for a portion of our growth.

Our growth is dependent on both increases in sales in existing stores and the ability to open new stores. Unavailability of store locations that we deem 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 our new store growth, the costs associated with new stores and/or the profitability of new stores. Our ability to renew or enter into new leases on favorable terms could affect costs of operations or slow store expansions.

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

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

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

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

We may be subject to product liability claims.

Despite our best efforts to ensure the quality and safety of the products we sell, we may be subject to product liability claims from customers or penalties from government agencies relating to products, including food products that are recalled, defective or otherwise alleged to be harmful. Such claims may result from tampering by unauthorized third parties, product contamination or spoilage, including the presence of foreign objects, substances, chemicals, other agents, or residues introduced during the growing, storage, handling and transportation phases. All of our vendors and their products must comply with applicable product and food safety laws. We generally seek contractual indemnification and insurance coverage from our suppliers. However, if we do not have adequate insurance or contractual indemnification available, such claims could have a material adverse effect on our business, financial condition and results of operation. Our ability to obtain indemnification from foreign suppliers may be hindered by the manufacturers' lack of understanding of U.S. product liability or other laws, which may make it more likely that we be required to respond to claims or complaints from customers as if we were the manufacturer of the products. Even with adequate insurance and indemnification, such claims could significantly damage our reputation and consumer confidence in our products. Our litigation expenses could increase as well, which also could have a materially negative impact on our results of operations even if a product liability claim is unsuccessful or is not fully pursued.

Our ability to achieve the results of store closures under our strategic plan initiatives could adversely affect our business.

As part of our continuing operations, we perform research and analysis to discover potential underperforming stores. We use such research and analysis to identify potential store closures. 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.

Adverse impacts associated with the current economic and financial crisis could affect our business.

The lingering economic downturn could have an adverse impact of our business and profitability. Many consumers have fallen prey to the current crisis either as a result of job losses, foreclosures, or their inability to obtain short-term financing, all of which could negatively affect their ability to shop in our stores and buy our products. Additionally, decreased consumer demand resulting from a pronounced negative consumer sentiment and an increasing personal savings rate could also negatively affect our sales and profits. Also, our ability to obtain financing, should the need arise outside of our current contractual credit facility, could be at risk due to restrictive lending practices in the wake of the liquidity crisis in the United States financial system.

ITEM 1B: Unresolved Staff Comments

None.

ITEM 2: Properties

As of January 29, 2011, the geographical distribution of the Company’s 653 retail store locations in 15 states was as follows:

State	Number of Stores
Georgia	111
Mississippi	113
Alabama	92
Tennessee	86
Arkansas	68
South Carolina	55
Louisiana	48
North Carolina	21
Texas	18
Florida	12
Kentucky	15
Illinois	6
Missouri	6
Indiana	1
Oklahoma	1
	653

The Company owns the real estate and the buildings for 77 locations, of which 4 are closed, 10 are subleased and 5 are subject to ground leases. Six of these locations are encumbered by mortgages (see Note 3 – Indebtedness). The Company leases the remaining 576 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 25,000 square feet. Three hundred and sixty-four 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 approximately 850,000 square feet of distribution center 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 December 2008, a lawsuit entitled Whiteaker, et al v. FRED’S Stores of Tennessee, Inc., et al, was filed in the United States District Court in the Northern District of Mississippi, in which the plaintiffs allege past and future damages as a result of a 2006 trip and fall accident at a Fred's store. The Company denied liability and vigorously defended the case on its merits. In accordance with FASB ASC 450, "Contingencies", the Company did not feel that a loss in this matter was probable or could be reasonably estimated. However, on November 17, 2010, a jury rendered a $1.1 million verdict and apportioned the Company with 81% fault. This case is covered by the Company's General Liability insurance, which has a $250,000 deductible. The Company is discussing all of its options, including, post-trial options and appeals. On or about February 4, 2011, the trial judge set aside a verdict amount as being excessive but left in effect the percentage of fault and ordered a new trial on damages only.

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, but the court has not 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 FASB ASC 450, "Contingencies", the Company does not feel that a loss in this matter is probable or can be reasonably estimated. Therefore, we have not recorded a liability for this case.

In August 2007, a lawsuit entitled Julia Atchinson, et al. v. FRED'S Stores of Tennessee, Inc., et al, was filed in the United States District Court for the Northern District of Alabama, Southern Division in which the plaintiff alleged 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 sought to recover overtime pay, liquidated damages, attorney's fees and court costs. Although the Company continues to believe that its assistant store managers are and have been properly classified as exempt employees under FLSA and that the matter was not appropriate for collective action treatment, the parties agreed to mediate this case in January 2009 and did so successfully, reaching a settlement of $1.5 million (including attorneys' fees and costs). The court approved the settlement and the Company subsequently paid it in August 2010. Based on the substantial costs of continuing litigation, unfavorably high jury verdicts against other retailers and the constant distraction to management of a possible protracted jury trial, we believe that this is a favorable settlement for FRED'S. FRED'S has admitted no liability or wrongdoing, and no liability or wrongdoing has been found against the Company.

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 4: Removed and Reserved

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 2010 and fiscal 2009.

	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
Fiscal 2010				
High	$ 14.39	$ 14.30	$ 12.98	$ 14.40
Low	$ 9.07	$ 10.16	$ 10.36	$ 11.70
Dividends	$ 0.04	$ 0.04	$ 0.04	$ 0.04
Fiscal 2009				
High	$ 14.17	$ 14.85	$ 14.00	$ 12.18
Low	$ 8.52	$ 11.91	$ 11.68	$ 9.01
Dividends	$ 0.02	$ 0.03	$ 0.03	$ 0.03

The Company's stock price at the close of the market on April 12, 2011 was $13.21. As of April 12, 2011, there were approximately 13,000 shareholders, including beneficial owners holding shares in nominee or street name. 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. As part of that review and in light of the Company's current financial position, the Board of Directors raised the dividend from $.03 per share to $.04 per share in the first quarter of 2010. On March 2, 2011, the Board of Directors increased the dividend to shareholders of record as of March 10, 2011 to $.05, a 25 % increase. 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 January 29, 2011, 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 Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c)
Stock option plans approved by security holders	918,462	$ 12.15	1,446,199

Employee stock purchase plan	4,368	$ 11.32	1,026,833
Equity Compensation plans not approved by security holders	-	-	-
Total	922,830	$ 12.15	2,473,032

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 at January 29, 2011 (amounts in thousands, except price data). The repurchased shares have been cancelled and returned to authorized but unissued shares.

	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Program	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Program
Balance at January 30, 2010				2,830.8
January 31 - February 27, 2010	69.3	$ 9.38	69.3	2,761.5
February 28 - April 3, 2010	-	$ -	-	2,761.5
April 4, - May 1, 2010	-	$ -	-	2,761.5
May 2, - May 29, 2010	-	$ -	-	2,761.5
May 30, - July 3, 2010	-	$ -	-	2,761.5
July 4, - July 31, 2010	222.6	$ 10.43	222.6	2,538.9
August 1, - August 28, 2010	1.1	$ 10.50	1.1	2,537.8
August 29, - October 2, 2010	-	$ -	-	2,537.8
October 3, - October 30, 2010	-	$ -	-	2,537.8
October 31, - November 27, 2011	-	$ -	-	2,537.8
November 28, - January 1, 2011	-	$ -	-	2,537.8
January 2, - January 29, 2011	-	$ -	-	2,537.8

The remainder of the information required by this item is incorporated herein by reference to our 2010 annual report to shareholders.

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)	2010	2009	20084	2007 4	2006 2 & 3
Statement of Income Data:					
Net sales	$1,841,755	$1,788,136	$1,798,840	$1,780,923	$1,767,239
Operating income	46,718	38,494	26,318	16,457	40,949
Income before income taxes	46,528	38,201	25,910	15,664	40,213
Provision for income taxes	16,941	14,586	9,268	4,946	13,467
Net income	29,587	23,615	16,642	10,718	26,746
Net income per share:					
Basic	0.76	0.59	0.42	0.27	0.67
Diluted	0.75	0.59	0.42	0.27	0.67
Cash dividends declared per share	0.16	0.11	0.08	0.08	0.08
Selected Operating Data:					
Operating income as a percentage of sales	2.5 %	2.2 %	1.5 %	0.9 %	2.3 %
Increase in comparable store sales 1	2.2 %	0.4 %	1.8 %	0.3 %	2.4 %
Stores open at end of period	653	645	639	692	677
Balance Sheet Data (at period end):					
Total assets	$595,528	$571,441	$544,775	$550,572	$515,709
Short-term debt (including capital leases)	201	718	243	285	737
Long-term debt (including capital leases)	3,969	4,179	4,866	35,653	2,331
Shareholders' equity	423,888	400,939	387,081	372,059	369,268

1 A store is first included in the comparable store sales calculation after the end of the 12th month following the store's grand opening month (see additional information regarding calculation of comparable store sales in "Results of Operations" section).
2 Results for 2006 include 53 weeks.
3 Results for 2006 include the implementation of ASC 718.
4 Results include certain charges for the non-routine closing of 75 stores in 2008 and 17 in 2007, (see "Exit and Disposal Activities" section) and implementation of ASC 740.

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

General Accounting Periods

The following information contains references to years 2010, 2009 and 2008, which represent fiscal years ended January 29, 2011, January 30, 2010 and January 31, 2009 (which were 52-week accounting periods). Amounts are in thousands unless otherwise noted. 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

We operate a chain of more than 650 discount general merchandise stores in fifteen states primarily in the southeastern United States. Our stores generally serve low, middle and fixed income families located in small- to medium- sized towns. Full service pharmacies are included in 313 of the Company’s stores. The Company also markets goods and services to 24 franchised “FRED’S” stores. Our Company was founded in 1947 and is headquartered in Memphis, Tennessee.

At the beginning of fiscal 2010, we introduced and began the roll-out of our Core 5 Program, which is a key strategic initiative designed to highlight key categories within our stores that differentiate us from our competition. The Core 5 categories - Home, Celebration, Pet, Pharmacy and Paper and Chemical - are strong trip driving departments in which FRED’S has a clear and marketable advantage versus small-box competitors. Additionally, these categories have high household penetration and resonate with customers across multiple demographics. This initiative is also intended to shift our product mix toward the more discretionary, higher margin categories and away from the lower margin consumable categories, thus driving higher margin and leading to increased operating profit. Early results of our Core 5 program are encouraging and we are pleased with the performance in 2010. We expect to build on this success in 2011.

Another significant initiative accomplished in 2010 was to remodel and refurbish more than 200 stores during the year, implementing our new layout that our team developed. The implementation of the Core 5 Program requires a moderate refresh of the store to address space allocation, product placement and adjacencies and signage in the Core 5 categories. The implementation is also accompanied by an extensive marketing campaign, including print advertising and direct mail, timed to coincide with the refresh of the store and then continuing for six months thereafter. We will continue the reinvestment in stores in 2011, targeting 200 additional remodels and upgrades to be completed. When these are completed, we will have approximately 75% of our stores with the upgraded Fred’s store look and feel.

Another key element of our strategy in 2010 was the introduction of new major national brand product lines such as Coca-Cola, Purina, and Energizer. Our customer response has been favorable. Sales and customer traffic have exceeded expectations. We will continue to review additional opportunities to add strong national brands to our merchandise mix.

In step with the brand name product expansion, 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 approximately 9.0% of total sales, and that number will continue to grow in the future 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 health and beauty care, food, paper and chemicals, and party goods introduced during 2010.

Recognizing our pharmacy department as a key factor differentiating us from 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 buying prescription files, but cold start openings will be employed where it makes sense to do so. We offer Fred's Prescription Plus Program which includes $4 generic pricing on over 300 different drugs in all pharmacies in the chain. We consider this program to be a strong traffic driver and includes over 300,000 members in the program.

Gross margin improvement continues to be a major focus of the Company, as highlighted above with our Core 5 and Own Brand strategies. We are aggressively pursuing product sourcing improvements and cost reductions across all product lines in order to reduce overall product costs and, in turn, raise our gross margin. Additionally, we have implemented new processes intended to control both promotional and clearance markdowns. We also continue to make improvements in our loss prevention processes and procedures, and those improvements are leading to reduced shrinkage in our stores and, consequently, higher gross margin. These efforts resulted in a 70 basis point improvement in gross margin in 2010 when compared to the previous year.

Expense containment continues to be a 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.

Throughout 2010, we have continued with capital improvements in infrastructure, distribution center upgrades and further development of our information technology capabilities. Technology upgrades have been made in the areas of merchandising allocations systems, human resources and payroll systems, in-store systems, and pharmacy systems.

Looking to 2011, we recognize the need to further refine Fred's differentiated strategy as we continue to adapt to an evolving retail environment. Our Core 5 program will be an ongoing catalyst for comparable store sales growth and gross margin improvement. We will continue to reinvest in our stores targeting 200 additional remodels and upgraded stores in 2011. When these are completed, we will have refreshed approximately 75% of our chain with the work completed over the 2010 and 2011 years. We will continue our initiatives of improving the fundamentals of the business, improving the merchandising and marketing programs, expanding national and own brand products, raising talent levels throughout the Company, and better customer service.

We will accelerate new store growth from 15 stores in 2010 to 20 to 25 stores in 2011. Our store growth will be focused in those areas where market share and brand awareness are strong, providing a greater potential for success. We will open approximately 15 to 20 pharmacies in 2011.

We continue to view our pharmacy department growth as a solid use of invested capital. Despite regulatory changes to impact reimbursement rates on pharmaceuticals that may impact sales and margin in 2011, our optimism remains strong about the future of pharmacy growth due to the customer loyalty it brings to our stores. On average, stores with a pharmacy department have higher general merchandise sales, consistently running at 10% or better than stores without pharmacies. With the aging population growth, new generic drugs being introduced, healthcare reform legislation, and expanding clinical services by pharmacists, we expect pharmacy scripts to continue increasing at an accelerated pace in 2011 and beyond.

Building on the improvements made this past year, we expect to continue driving higher sales, operating margin, and earnings. For the full year, we expect total sales to increase 3% to 5%, driven by the acceleration in new stores and a comparable store increase of 2% to 4%. We anticipate the general merchandise comparable store sales increases to outpace the pharmacy department sales in 2011 due to the continued shift from brand to generic scripts. This shift has an adverse effect on sales as branded drugs carry a significantly higher selling price than generic drugs. We are planning pharmacy department comparable store sales to be relatively flat in 2011.

Earnings per diluted share for 2011 are projected to be in the range of $0.84 to $0.90, an increase of 12% to 20% over 2010 actual results. Our earnings expectation considers the impact of anticipated reductions in state Medicaid reimbursements on pharmacy department sales and margins totaling $3 million to $6 million or $0.05 to $0.10 per diluted share.

Capital expenditures for 2011 are expected to be in the range of $28 million to $31 million. Additionally, $12 million to $13 million is planned related to acquisitions of pharmacies during 2011.

A breakdown of capital expenditures is as follows:

- Continuation of the Core 5 Program rollout, $8 million to 10 million
- New stores and pharmacies, $6 million to $7 million,
- Existing store maintenance, $8 million
- Distribution, $2 million

- Technology and corporate upgrades, $4 million

Critical factors to the Company’s future success include the successful execution of our Core 5 program, as well as managing the strategy for opening new stores and pharmacies, 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 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 2011 include the continuing impacts of the changing regulatory environment in which our pharmacy department operates. Additionally, we believe that high unemployment, rising fuel prices, and other inflationary impacts continues 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 for our customer base and positions us well to continue growing market share.

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. Our 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 January 29, 2011. 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 aged liabilities 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 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 2010, 2009 and 2008 was $1,995, $2,087 and $2,145, 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 Generally Accepted Accounting Principles in the 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; thus the following paragraph describes our estimation method as well as the steps we take to mitigate the risk of this estimate has 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 experienced improvement in reducing shrink as a percentage of sales from year to year due to improved inventory control measures, which includes the chain-wide utilization of the NEX/DEX technology.

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 $32.5 million, and $30.2 million at January 29, 2011 and January 30, 2010, 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 $24.0 million at January 29, 2011 and $21.5 million at January 30, 2010. The LIFO reserve increased by approximately $2.4 million and $2.4 million during 2010 and 2009, respectively.

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, accounting, information technology and human resources, as well as inbound freight. The total amount of procurement and storage costs and inbound freight included in merchandise inventory at January 29, 2011 is $19.5 million compared to $17.4 million at January 30, 2010.

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 FASB ASC 360, "Impairment or Disposal of Long-Lived Assets," we review for impairment all stores open at least 3 years or remodeled more than 2 years. Impairment results when the carrying value of the assets exceeds the undiscounted future cash flows over the life of the lease or 10 years for owned stores. 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.

Exit and Disposal Activities. During fiscal 2007, the Company closed 17 underperforming stores.

During fiscal 2008, the Company closed 74 underperforming stores and 23 underperforming 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 previous 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 fiscal 2009, the Company closed 9 underperforming stores, which is consistent with our anticipated amount of annual store closures in the normal course of business. Therefore, store closures of this nature in this and future years are not deemed exit and disposal related activities.

Inventory Impairment

During fiscal 2007, we recorded a below-cost inventory adjustment of approximately $10.0 million to reduce the value of inventory to lower of cost or market in stores that were planned for closure as part of the Company's strategic plan to improve profitability and operating margin. The adjustment was recorded in cost of goods sold in the consolidated statement of income for the year ended February 2, 2008.

In fiscal 2008, we recorded an additional below-cost inventory adjustment of $0.3 million to reduce the value of inventory to lower of cost or market associated with stores closed in the third quarter and utilized the entire $10.3 million impairment.

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 FASB ASC 420, “Exit or Disposal Cost Obligations”. 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 FASB ASC 420. 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, we closed 17 underperforming 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 year 2008.

During fiscal 2008, we closed 74 underperforming 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 $7.7 million during the period, leaving $3.4 million in the reserve at January 31, 2009.

During fiscal 2009, we reserved an additional $0.1 million in rent expense related to the 9 store closings. We utilized $2.4 million during the period, leaving $1.1 million in the reserve at January 30, 2010.

During fiscal 2010, we reserved an additional $0.6 million in rent expense related to the revision of the estimated amount of the remaining lease liability for the fiscal 2008 and 2009 store closures. We also utilized $1.0 million, leaving $.7 million in the reserve at January 29, 2011.

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

	Beginning Balance January 30, 2010	Additions FY10	Utilized FY10	Ending Balance January 29, 2011
Lease contract termination liability	$ 1.1	$ 0.6	$ (1.0)	$ 0.7

Fixed Asset Impairment

During the fourth quarter of 2007, the Company recorded 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 2008. During the second quarter of fiscal 2008, the Company recorded an additional charge of $.1 million associated with store closures that occurred in the third quarter. Impairment of $0.2 million for the planned store closures was recorded in 2009.

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. 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 - 31.5 years
Furniture, fixtures and equipment	3 - 10 years
Leasehold improvements	3 - 10 years or term of lease, if shorter
Automobiles and vehicles	3 - 6 years
Airplane	9 years

Assets under capital lease 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 and Advertising Costs. 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 FASB ASC 605-50 "Customer Payments and Incentives", 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 January 29, 2011, the Company had approximately 950 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 a month to longer-term arrangements that could last up to three years.

In accordance with FASB ASC 720-35 "Advertising Costs", 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 2010, 2009 and 2008, were $24.5 million, $24.0 million and $24.1 million, respectively. Gross advertising expenses were reduced by vendor cooperative advertising allowances of $2.4 million, $2.6 million and $2.3 million, for 2010, 2009 and 2008, 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 $500,000 for property and general liability and $200,000 for employee medical. The Company's insurance reserve was $10.3 million and $9.0 million on January 29, 2011 and January 30, 2010, respectively. Changes in the reserve over that time period were attributable to additional reserve requirements of $47.3 million netted with reserve utilization of $46.0 million.

Income Taxes. The Company reports income taxes in accordance with FASB ASC 740, "Income Taxes." Under FASB ASC 740, 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 (see Note 4 – Income Taxes).

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48 ("FASB ASC 740"), Accounting for Uncertainty in Income Taxes — an Interpretation of FASB Statement No.109 that is codified in FASB ASC 740. We adopted FASB ASC 740 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 FASB ASC 740 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 FASB ASC 740, 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, FASB ASC 740 provides guidance on de-recognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition (see Note 4 – Income Taxes).

FASB ASC 740 further requires that interest and penalties required to be paid 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 FASB ASC 740 in the financial statements as a component of income tax expense. As of January 29, 2011, accrued interest and penalties related to our unrecognized tax benefits totaled $1.3 million and $0.3 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 FASB ASC 718, “Compensation – Stock Compensation”, 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 FASB ASC 718, 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 FASB ASC 718. Results for prior periods have not been restated.

Effective January 29, 2006, the Company elected to adopt the alternative transition method provided in FASB ASC 718 for calculating the income tax effects of stock-based compensation. 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 FASB ASC 718.

FASB ASC 718 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. The impact of adopting FASB ASC 718 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.

Stock-based compensation expense, post adoption of FASB ASC 718, 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.

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					
	January 29, 2011		January 30, 2010		January 31, 2009 3	
Net sales	100.0	%	100.0	%	100.0	%
Cost of good sold 1	71.4		72.1		72.0	
Gross profit	28.6		27.9		28.0	
Selling, general and administrative expenses 2	26.1		25.8		26.5	
Operating income	2.5		2.1		1.5	
Interest expense, net	-		-		0.1	
Income before taxes	2.5		2.1		1.4	
Income taxes	0.9		0.8		0.5	
Net income	1.6	%	1.3	%	0.9	%

1 Cost of goods sold includes the cost of 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 include certain charges for the non-routine closing of 75 stores in 2008 (see Item 7, "Exit and Disposal Activities" section).

Comparable Store Sales. Our calculation of comparable store sales represents the increase or decrease in net sales for stores that have been opened after the end of the 12th month following the store's grand opening month, and includes 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 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 2010 Compared to Fiscal 2009

Sales
Net sales for 2010 increased to $1,841.8 million from $1,788.1 million in 2009, a year-over-year increase of $53.6 million or 3.0%. On a comparable store basis, sales for 2010 increased 2.2% ($33.3 million) compared with a 0.4% ($6.2 million) increase in the same period last year.

The Company's 2010 front store (non-pharmacy) sales increased 2.1% over 2009 front store sales We experienced sales increases in categories such as direct beverage, small appliances, greeting cards and tobacco partially offset by decreases in food and electronics.

The Company's pharmacy sales were 34.2% of total sales in 2010 compared to 33.5% of total sales in the prior 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 5.2% over 2009, 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 2010 decreased to $37.4 million (2.0% of sales) from $38.4 million (2.2% of sales) in 2009. The decrease in year-over-year franchise sales continues to be impacted by the ongoing economic challenges affecting our customers' disposable income. The Company does not intend to expand its franchise network.

The sales mix for the period, unadjusted for deferred layaway sales, was 34.1% Pharmaceuticals, 24.1% Household Goods, 16.2% Food and Tobacco, 8.6% Paper and Cleaning Supplies, 7.6% Apparel and Linens, 7.4% Health and Beauty Aids, and 2.0% Franchise. The sales mix for the same period last year was 33.5% Pharmaceuticals, 23.4% Household Goods, 16.2% Food and Tobacco, 9.2% Paper and Cleaning Supplies, 7.9% Apparel and Linens, 7.6% Health and Beauty Aids, and 2.2% Franchise.

For the year, comparable store customer traffic increased .3% over last year while the average customer ticket increased 1.6% to $19.75.

Gross Profit
Gross profit for the year increased to $527.0 million in 2010 from $499.2 million in 2009, a year-over-year increase of $27.8 million or 5.6%. Gross margin, measured as a percentage of sales, increased to 28.6% in 2010 from 27.9% in 2009, a 70 basis point improvement. Gross margin was favorably impacted by the improved product mix shift toward household goods which carry higher margins, continued management of shrink in our stores, improved pharmacy department margins and an increase in vendor consideration. This favorability was partially offset by an increase in store markdowns and pharmacy shrinkage.

Selling, General and Administrative Expenses
Selling, general and administrative expenses, including depreciation and amortization, increased to $480.3 million in 2010 (26.1% of sales) from $460.7 million in 2009 (25.8% of sales). This 30 basis point expense deleveraging resulted primarily from the increase in labor of $8.8 million and amortization expense of $2.5 million related mainly to pharmacy acquisitions during the year, as well as an increase in incentive compensation of $2.6 million.

Operating Income
Operating income increased to $46.7 million in 2010 (2.5% of sales) from $38.5 million in 2009 (2.1% of sales) due primarily to an increase in gross profit of $27.8 million due to the improved product mix shift toward household goods

which carry higher margins, continued management of shrink in our stores, improved pharmacy department margins and an increase in vendor dollar consideration. This favorability was partially offset by an increase in selling, general and administrative expenses of $19.6 million as described in the Selling, General and Administrative Expenses section above.

Interest Expense, Net

Net interest expense for 2010 totaled $.2 million or less than .1% of sales compared to $.3 million which was also less than .1% of sales in 2009.

Income Taxes

The effective income tax rate was 36.4% in 2010 compared to 38.2% in 2009. The decrease in the effective tax rate was primarily due to the finalization and settlement of the Internal Revenue Exam which was incurred in 2009.

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 $142.5 million for state income tax purposes and expire at various times during 2011 through 2029. 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 be in the range of 36% - 37% in fiscal 2011.

Net Income

Net income increased to $29.6 million ($.75 per diluted share) in 2010 from $23.6 million ($.59 per diluted share) in 2009, a 25.3% increase. The increase in net income is primarily attributable to the favorable gross profit of $27.8 million as described in the Gross Profit section above. This favorability was partially offset by the $19.6 million increase in selling, general and administrative expenses as described in the Selling, General and Administrative Expenses section above, as well as higher income tax expense due to a pretax income increase of $8.3 million.

Fiscal 2009 Compared to Fiscal 2008

Sales

Net sales for 2009 decreased to $1,788.1 million from $1,798.8 million in 2008, a year-over-year decrease of $10.7 million or .6%. Excluding sales from stores closed in 2008 ($40.3 million), total sales were up $29.6 million or 1.7% over the prior year. On a comparable store basis, sales for 2009 increased .4% ($6.2 million) compared with a 1.8% ($29.1 million) increase in the prior year.

The Company's 2009 front store (non-pharmacy) sales decreased 3.2% over 2008 front store sales. Excluding the front store sales from stores closed in 2008 ($40.3 million), sales increased .2% over the prior year. We experienced sales increases in categories such as tobacco, food and small appliances partially offset by decreases in home furnishings, health and beauty aids and housewares.

The Company's pharmacy sales were 33.5% of total sales in 2009 compared to 31.5% of total sales in the prior 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 5.0% 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 2009 decreased to $38.4 million (2.2% of sales) from $39.6 million (2.2% of sales) in 2008. The decrease in year-over-year franchise sales continues to be impacted by the ongoing economic challenges affecting our customers' disposable income. The Company does not intend to expand its franchise network.

The sales mix for the period, unadjusted for deferred layaway sales, was 33.5% Pharmaceuticals, 23.4% Household Goods, 16.2% Food and Tobacco, 9.2% Paper and Cleaning Supplies, 7.9% Apparel and Linens, 7.6% Health and Beauty Aids, and 2.2% Franchise. The sales mix for the same period last year was 31.7% Pharmaceuticals, 24.8% Household Goods, 15.5% Food and Tobacco, 9.2% Paper and Cleaning Supplies, 8.6% Apparel and Linens, 8.0% Health and Beauty Aids, and 2.2% Franchise.

For 2009, comparable store customer traffic decreased .1% over the prior year while the average customer ticket increased 1.0% to $19.29.

Gross Profit

Gross profit for the year decreased to $499.2 million in 2009 from $503.0 million in 2008, a year-over-year decline of $3.8 million or .8%. Gross margin, measured as a percentage of sales, declined to 27.9% in 2009 from 28.0% in 2008. Gross margin was unfavorably impacted by continued competitive pressures, higher promotional markdowns, and an unfavorable shift in the product mix toward lower margin basic and consumable products. Gross profit was also favorably impacted, primarily in the third and fourth quarter, by purchase price variances related to those and previous quarters. These purchase price variances resulted from reduced product costs obtained from vendors. The impact on prior quarters was immaterial. This unfavorability was partially offset by an increase in vendor dollar consideration and higher general merchandise department markup and reduced shrink.

Selling, General and Administrative Expenses
Selling, general and administrative expenses, including depreciation and amortization, decreased to $460.7 million in 2009 (25.8% of sales) from $476.7 million in 2008 (26.5% of sales). This 70 basis point expense leveraging resulted primarily from the effect of our store closures in fiscal 2008 ($9.6 million), a reduction in professional fees primarily due to the legal costs related to the settlement of the Atchinson and Ziegler cases recorded in fiscal 2008 ($6.6 million) (see Item 3. Legal Proceedings in our 10-K filed April 16, 2009). In addition, we continued to manage costs in our stores by reducing labor expense ($2.8 million) and lowering utilities expense ($2.2 million) with the installation of Energy Management Systems. This favorability was partially offset by deleveraging in our pharmacy labor and depreciation expense related to new pharmacy openings during the fiscal year.

Operating Income
Operating income increased to $38.5 million in 2009 (2.1% of sales) from $26.3 million in 2008 (1.5% of sales) due primarily to a decrease in selling, general and administrative expenses as the Company did not incur expenses related to store closures in 2009 and did not experience the one-time legal costs as in 2008, referenced in the Selling, General and Administrative Expenses section above. This favorability was partially offset by a decrease in gross profit of $3.8 million, a year-over-year decline of .8%, as described in the Gross Profit section above.

Interest Expense, Net
Net interest expense for 2009 totaled $.3 million or less than .1% of sales compared to $.4 million which was also less than .1% of sales in 2008.

Income Taxes
The effective income tax rate was 38.2% in 2009 compared to 35.8% in 2008. The increase in the effective tax rate was primarily due to an increase in the valuation allowance associated with deferred state tax benefits which management has determined are more likely than not to expire unused.

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 $142.5 million for state income tax purposes and expire at various times during 2011 through 2029. 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.

Net Income
Net income increased to $23.6 million ($.59 per diluted share) in 2009 from $16.6 million ($.42 per diluted share) in 2008. The increase in net income is primarily attributable to the decrease in selling, general and administrative expenses of 3.3% resulting from the effect of our store closures in fiscal 2008 ($9.6 million) and the legal costs related to the settlement of the Atchinson case also in 2008 ($5.0 million) (see Item 3. Legal Proceedings from our 10-K filed April 16, 2009). This favorability was partially offset by the $3.8 million reduction in gross profit as described within the caption Gross Profit above, as well as increased income taxes due to a $12.3 million increase in pretax income and an increased tax rate resulting from the final settlement of the IRS audit.

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 $282.1 million, $266.7 million and $255.5 million at year-end 2010, 2009 and 2008, respectively. Working capital fluctuates in relation to profitability, seasonal inventory levels, and the level of store openings and closings. Working capital at year-end 2010 increased by $15.4 million from 2009. The increase was primarily due to an inventory increase of $19.4 million as a result of an additional of toy and trim-a-home inventory purchased for the 2010 holiday season and a strategic decision to purchase import goods earlier in an effort to avoid business interruptions from the Chinese New Year, and a decrease in accounts payable of $6.4 million related to the timing of pharmacy inventory payments. The increase described above was partially offset by a year-over-year decrease in cash and cash equivalents of $5.6 million and an increase in accrued expenses of $5.8 million. In 2011, the Company intends to open approximately 20 - 25 stores and pharmacies and close an estimated 10 stores and 15 pharmacies.

We have incurred losses caused by fire, tornado and flood damage, which consisted primarily of losses of inventory and fixed assets. 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 $42.1 million in 2010, $64.2 million in 2009 and $78.3 million in 2008.

In fiscal 2010, inventory, net of the LIFO reserve, increased by approximately $19.4 million due to many factors including our drive to support our in-stock position, an additional of toy and trim-a-home inventory purchased for the 2010 holiday season and a strategic decision to purchase import goods earlier in an effort to avoid business interruptions from the Chinese New Year. Accounts receivable increased by approximately $6.2 million due primarily to an increase in vendor related allowances. Accounts payable and accrued expenses decreased by approximately $.6 million. Income taxes payable increased by $3.8 million while deferred income tax liability increased by $1.9 million. Other non-current liabilities increased by $.7 million.

In fiscal 2009, inventory, net of the LIFO reserve, decreased by approximately $7.5 million due to higher inventory turn rates in our stores, the average of which has increased to 4.1 in fiscal 2009 from 3.8 in fiscal 2008. Accounts receivable increased by approximately $1.6 million due primarily to an increase in vendor related allowances. Accounts payable and accrued expenses increased by approximately $11.4 million primarily as a result of the focus on improving our terms with our vendors. Income taxes payable decreased by $8.0 million while deferred income tax expense increased by $5.9 million. Other non-current liabilities decreased by $3.4 million due to a reduction in the Company FASB ASC 740 reserves.

In fiscal 2008, inventory, net of the LIFO reserve, decreased by approximately $18.5 million due to the store and pharmacy closing throughout the year, as well as reductions in discretionary product classes where sales decreased in 2008. Accounts receivable decreased by approximately $5.4 million due primarily to a decrease of an income tax receivable that was created in the prior year. Accrued expenses increased by approximately $5.5 million primarily as a result of the $6.6 million legal accrual related to the settlement of the Ziegler and Atchinson cases in the fourth quarter of 2008. Other non-current liabilities increased by $8.7 million due to an increase in the Company FASB ASC 740 reserves.

Net cash used in investing activities totaled $38.2 million in 2010, $33.2 million in 2009 and $19.7 million in 2008.

Capital expenditures in 2010 totaled $27.0 million compared to $22.7 million in 2009 and $17.0 million in 2008. The capital expenditures during 2010 consisted primarily of the store and pharmacy expansion program ($22.4 million), technology enhancements ($2.9 million), transportation and distribution center expenditures ($1.0 million) and other corporate expenditures ($.7 million). Capital expenditures in 2009 totaled $22.7 million compared to $17.0 million in 2008 and $31.4 million in 2007. The capital expenditures during 2009 consisted primarily of the store and pharmacy expansion program ($15.7 million), technology enhancements ($3.3 million), transportation and distribution center expenditures ($2.1 million) and other corporate expenditures ($1.6 million). Capital expenditures during 2008 consisted primarily of the store and pharmacy expansion program ($13.7 million), technology and other corporate expenditures ($2.2 million) and improvements at our two distribution centers ($1.1 million).

In 2011, the Company is planning capital expenditures totaling approximately $29.0 million. Expenditures are planned totaling $22.9 million for new and existing stores and pharmacies. Planned expenditures also include approximately $3.6 million for technology upgrades and approximately $2.5 million for distribution center equipment and other capital maintenance. Technology upgrades in 2011 will be made to our mainframe software and hardware and in the area of Payment Card Industry compliance (PCI). In addition, the Company plans expenditures of approximately $12.5 million in 2011for the acquisition of prescription lists and other pharmacy related items.

Net cash used in financing activities totaled $9.4 million in 2010, $11.4 million in 2009 and $33.7 million in 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. As part of that review and in light of the Company's current financial position, the Board of Directors raised the dividend from $.03 per share to $.04 per share in the first quarter of 2010, for a total of $.16 in 2010. The Company has paid cash dividends of $6.3 million in 2010, $4.4 million in 2009 and $3.2 million in 2008. On March 2, 2011, the Board of Directors increased the dividend to shareholders of record as of March 10, 2011 to $.05, a 25 % increase.

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 2010, the Company repurchased 293,000 shares for $3.0 million and 742,663 shares for $7.2 million in 2009. There were no share repurchases in fiscal 2008.

On September 27, 2010, the Company and Regions Bank entered into the Tenth Loan Modification of the Revolving Loan and Credit Agreement which decreased the credit line from $60 million to $50 million and extended the term until September 27, 2013. All other terms, conditions and covenants remained in place after the amendment, with only a slight modification to one of the financial covenants required by the Agreement. Under the most restrictive covenants of the Agreement, the Company is required to maintain specified shareholders' equity (which was $327.2 million at January 29, 2011) and positive net income levels. The Company was in compliance with all loan covenants at January 29, 2011. Borrowings and the unused fees under the agreement bear interest at a tiered rate based on the Company's previous four quarter average of the Fixed Charge Coverage Ratio. Currently the Company's rates are 112.5 basis points over LIBOR for borrowings and 22.5 basis points over LIBOR for the unused fee. There were no borrowings outstanding under the Agreement at January 29, 2011 and January 30, 2010.

Cash and cash equivalents were $49.2 million at the end of 2010 compared to $54.7 million at the end of 2009 and $35.1 million at the end of 2008. 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.

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 2010, 2009 and 2008.

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 a percentage 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.

The following table summarizes the Company's significant contractual obligations as of January 29, 2011, which excludes the effect of imputed interest:

(dollars in thousands)	2011	2012	2013	2014	2015	Thereafter	Total
Operating leases 1	$ 46,266	$ 39,852	$ 29,073	$ 19,981	$ 14,032	$ 25,561	$ 174,765
Inventory purchase obligations 2	105,966						105,966
Equipment leases 3	2,487	1,469	1,066	945	710	916	7,593
Mortgage loans on land & buildings and other 4	201	170	1,109	525	520	1,645	4,170
Postretirement benefits 5	41	41	44	46	44	241	457
Total contractual obligations	$ 154,961	$ 41,532	$ 31,292	$ 21,497	$ 15,306	$ 28,363	$ 292,951

1 Operating leases are described in Note 5 to the Consolidated Financial Statements.
2 Inventory purchase obligations represent open purchase orders and any outstanding purchase commitments as of January 29, 2011.
3 Equipment leases represent the cooler program and other equipment operating leases.
4 Mortgage loans for purchased land and buildings and other debt.
5 Postretirement benefits are described in Note 9 to the Consolidated Financial Statements.

The Company had commitments approximating $10.5 million at January 29, 2011 and $8.8 million at January 30, 2010 on issued letters of credit, which support purchase orders for merchandise. Additionally, the Company had outstanding letters of credit aggregating approximately $11.0 million at January 29, 2011 and $11.1 million at January 30, 2010 utilized as collateral for its 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 January 29, 2011, Atlantic Retail Investors, LLC, which is partially owned by Michael J. Hayes, Chairman of the Board of Directors, owned 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 store leases of the Company. The total rental payments related to these leases were $1.3 million for both years ended January 29, 2011 and January 30, 2010. Total future commitments under related party leases are $7.9 million.

In February 2011, Atlantic Retail Investors, LLC, purchased the land and building occupied by one of Fred's stores, bringing the total related party leases to thirteen. The store was purchased by Atlantic Retail Investors, LLC from an independent landlord/developer. On March 30, 2011, Fred's purchased ten of the thirteen properties leased from Atlantic Retail Investors, LLC, one of which has an additional parcel that is leased to an unrelated party.

Recent Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 168, "The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles – a replacement of SFAS No. 162" ("FASB ASC 105"). FASB ASC 105 modifies the GAAP hierarchy by establishing only two levels of GAAP, authoritative and nonauthoritative accounting literature. Effective July 2009, the FASB Accounting Standards Codification ("ASC"), also known collectively as the "Codification", is considered the single source of authoritative U.S. accounting and reporting standards, except for additional authoritative rules and interpretive releases issued by the SEC. The Codification was developed to organize GAAP pronouncements by topic so that users can more easily access authoritative accounting guidance. FASB ASC 105 became effective for the third quarter of fiscal year 2009. All other accounting standards references have been updated in this report with ASC references.

ITEM 7A: Quantitative and Qualitative Disclosure about Market Risk

The Company has no holdings of derivative financial or commodity instruments as of January 29, 2011. 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.

ITEM 8: Financial Statements and Supplementary Data

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
FRED's, Inc.
Memphis, Tennessee

We have audited the accompanying consolidated balance sheets of FRED's, Inc. (the "Company") as of January 29, 2011 and January 30, 2010 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 January 29, 2011. 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 January 29, 2011 and January 30, 2010, and the results of its operations and its cash flows for each of the three years in the period ended January 29, 2011, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), FRED's, Inc.'s internal control over financial reporting as of January 29, 2011, 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 14, 2010 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

Memphis, Tennessee

April 14, 2011

CONSOLIDATED BALANCE SHEETS
(in thousands, except for number of shares)

	January 29, 2011	January 30, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	$49,182	$54,742
Receivables, less allowance for doubtful accounts of $1,218 and $764, respectively	28,146	28,893
Inventories	313,384	294,024
Other non-trade receivables	26,378	25,193
Prepaid expenses and other current assets	12,723	10,945
Total current assets	429,813	413,797
Property and equipment, at depreciated cost	139,931	137,569
Equipment under capital leases, less accumulated amortization of $4,967 and $4,967, respectively	-	-
Intangible assets, net	22,193	16,035
Other noncurrent assets, net	3,591	4,040
Total assets	$595,528	$571,441
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$81,002	$87,393
Current portion of indebtedness	201	718
Accrued expenses and other	45,371	39,621
Deferred income taxes	21,142	19,373
Total current liabilities	147,716	147,105
Long-term portion of indebtedness	3,969	4,179
Deferred income taxes	2,069	2,009
Other noncurrent liabilities	17,886	17,209
Total liabilities	171,640	170,502
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, 39,300,872 and 39,363,462 shares issued and outstanding, respectively	131,367	131,685
Common stock, Class B nonvoting, no par value, 11,500,000 shares authorized, none outstanding	-	-
Retained earnings	291,649	268,350
Accumulated other comprehensive income	872	904
Total shareholders' equity	423,888	400,939
Total liabilities and shareholders' equity	$595,528	$571,441

See accompanying notes to condensed consolidated financial statements.

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

	For the Years Ended		
	January 29, 2011	January 30, 2010	January 31, 2009
Net sales	$1,841,755	$1,788,136	$1,798,840
Cost of goods sold	1,314,737	1,288,899	1,295,822
Gross profit	527,018	499,237	503,018
Depreciation and amortization	29,236	26,387	26,425
Selling, general and administrative expenses	451,064	434,356	450,275
Operating income	46,718	38,494	26,318
Interest income	(234)	(189)	(308)
Interest expense	424	482	716
Income before income taxes	46,528	38,201	25,910
Provision for income taxes	16,941	14,586	9,268
Net income	$29,587	$23,615	$16,642
Net income per share			
Basic	$0.76	$0.59	$0.42
Diluted	$0.75	$0.59	$0.42
Weighted average shares outstanding			
Basic	39,133	39,822	39,282
Effect of dilutive stock options	63	67	569
Diluted	39,196	39,889	39,851
Comprehensive income:			
Net income	$29,587	$23,615	$16,642
Other comprehensive income (expense), net of tax postretirement plan adjustment	(32)	(159)	23
Comprehensive income	$29,555	$23,456	$16,665

See accompanying notes to condensed consolidated financial statements.

FRED'S, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(in thousands, except share and per share amounts)

	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance, February 2, 2008	39,880,836	$ 135,335	$ 235,684	$ 1,040	$ 372,059
Cash dividends paid ($.08 per share)			(3,196)		(3,196)
Restricted stock grants, cancellations and withholdings, net	73,364	(35)			(35)
Issuance of shares under employee stock purchase plan	73,084	584			584
Stock-based compensation		990			990
Exercises of stock options	1,200	17			17
Income tax benefit on exercise of stock options		(14)			(14)
Adjustment for postretirement benefits (net of tax)			11	23	34
Net income			16,642		16,642
Balance, January 31, 2009	40,028,484	136,877	249,141	1,063	387,081
Cash dividends paid ($.11per share)			(4,406)		(4,406)
Restricted stock grants, cancellations and withholdings, net	16,691	(142)			(142)
Issuance of shares under employee stock purchase plan	60,350	542			542
Repurchased and cancelled shares	(742,663)	(7,152)			(7,152)
Stock-based compensation		1,595			1,595
Exercises of stock options	600	8			8
Income tax benefit on exercise of stock options		(43)			(43)
Adjustment for postretirement benefits (net of tax)				(159)	(159)
Net income			23,615		23,615
Balance, January 30, 2010	39,363,462	131,685	268,350	904	400,939
Cash dividends paid ($.16 per share)			(6,288)		(6,288)
Restricted stock grants, cancellations and withholdings, net	156,510	113			113
Issuance of shares under employee stock purchase plan	63,680	552			552
Repurchased and cancelled shares	(293,000)	(2,989)			(2,989)
Stock-based compensation		1,886			1,886
Exercises of stock options	10,220	130			130
Income tax benefit on exercise of stock options		(10)			(10)
Adjustment for postretirement benefits (net of tax)				(32)	(32)
Net income			29,587		29,587

Balance, January 29, 2011	39,300,872	$ 131,367	$ 291,649	$ 872	$ 423,888

See accompanying notes to condensed consolidated financial statements.

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

	For the Years Ended		
	January 29, 2011	January 30, 2010	January 31, 2009
Cash flows from operating activities:			
Net income	$29,587	$ 23,615	$ 16,642
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	29,236	26,387	26,425
Net (gain) loss on asset disposition	741	356	(831)
Provision for store closures and asset impairment	340	-	419
Stock-based compensation	1,886	1,595	990
Provision for uncollectible receivables	455	(121)	6
LIFO reserve increase	2,406	2,411	3,700
Deferred income tax expense (benefit)	1,898	5,932	(4,080)
Income tax benefit upon exercise of stock options	10	43	14
Provision for postretirement medical	(97)	(74)	34
(Increase) decrease in operating assets:			
Trade and non-trade receivables	(6,199)	(1,812)	5,405
Insurance receivables	1,390	(780)	902
Inventories	(22,106)	5,101	14,751
Other assets	(1,330)	1,369	(169)
Increase (decrease) in operating liabilities:			
Accounts payable and accrued expenses	(641)	11,593	5,537
Income taxes payable	3,813	(7,925)	1,178
Other noncurrent liabilities	668	(3,441)	7,362
Net cash provided by operating activities	42,057	64,249	78,285
Cash flows from investing activities:			
Capital expenditures	(27,013)	(22,692)	(16,727)
Proceeds from asset dispositions	168	125	2,182
Insurance recoveries for replacement assets	98	-	556
Asset acquisition, net (primarily intangibles)	(11,451)	(10,663)	(5,686)
Net cash used in investing activities	(38,198)	(33,230)	(19,675)
Cash flows from financing activities:			
Payments of indebtedness and capital lease obligations	(727)	(212)	(469)
Proceeds from revolving line of credit	-	-	205,996
Payments on revolving line of credit	-	-	(236,631)
Excess tax charges from stock-based compensation	(10)	(43)	(14)
Proceeds from exercise of stock options and employee stock purchase plan	595	408	566
Repurchase of shares	(2,989)	(7,152)	-
Cash dividends paid	(6,288)	(4,406)	(3,196)
Net cash used in financing activities	(9,419)	(11,405)	(33,748)
Increase in cash and cash equivalents	(5,560)	19,614	24,862

Cash and cash equivalents:			
Beginning of year	54,742	35,128	10,266
End of year	$49,182	$ 54,742	$ 35,128
Supplemental disclosures of cash flow information:			
Interest paid	$190	$ 293	$ 408
Income taxes paid	$7,145	$ 22,999	$ 2,559
Non-cash investing and financial activities:			
Assets acquired through term loan	$-	$ -	$ 274
Restricted stock issued for the aquistion of intangible assets	$200	$ -	$ -

See accompanying notes to consolidated financial statements.

Notes to Consolidated Financial Statements

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 January 29, 2011, the Company had 653 retail stores and 313 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. Amounts are in thousands unless otherwise noted.

Fiscal year. The Company utilizes a 52 — 53 week accounting period which ends on the Saturday closest to January 31. Fiscal years 2010, 2009 and 2008, as used herein, refer to the years ended January 29, 2011, January 30, 2010 and January 31, 2009, respectively. The fiscal years 2010, 2009 and 2008 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.

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 its 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 has 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 experienced improvement in reducing shrink as a percentage of sales from year to year due to improved inventory control measures, which includes the chain-wide utilization of the NEX/DEX technology.

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 $32.5 million and $30.2 million at January 29, 2011 and January 30, 2010, 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 $24.0 million at January 29, 2011 and $21.5 million at January 30, 2010. The LIFO reserve increased by approximately $2.4 million during 2010, $2.4 million during 2009 and $3.7 million during 2008.

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, accounting, information technology and human resources, as well as inbound freight. The total amount of procurement and storage costs and inbound freight included in merchandise inventory at January 29, 2011 is $19.5 million, with the corresponding amount of $17.4 million at January 30, 2010.

The Company did not record any below-cost inventory adjustments during the years ended January 29, 2011 and January 30, 2010 in connection with planned store closures (see Note 11 Exit and Disposal Activity).

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 - 31.5 years
Furniture, fixtures and equipment	3 - 10 years
Leasehold improvements	3 - 10 years or term of lease, if shorter

Automobiles and vehicles	3 - 6 years
Airplane	9 years

Assets under capital lease 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. We did not incur any depreciation expense on assets under capital lease for 2010 as the assets were fully depreciated.

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 FASB ASC 840 "Leases". The amount expensed but not paid was $1.0 million and $1.1 million at January 29, 2011 and January 30, 2010 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, electrical 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 FASB ASC 420, “Exit or Disposal Cost Obligations.” 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 FASB ASC 420. 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 FASB ASC 360, “Impairment or Disposal of Long-Lived Assets,” we review for impairment all stores open at least 3 years 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.

During 2008, the Company recorded a charge of $0.1 million associated with store closures that occurred in the third quarter. Impairment of $0.2 million for the planned store closures was recorded in 2009.

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. FASB ASC 605-50 “Customer Payments and Incentives” 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. Such consideration received from vendors is 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.

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

Advertising. In accordance with FASB ASC 720-35 “Advertising Costs”, 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 2010, 2009 and 2008, were $24.5 million, $24.0 million and $24.1 million, respectively. Gross advertising expenses were reduced by vendor cooperative advertising allowances of $2.4 million, $2.6 million and $2.3 million for 2010, 2009 and 2008, 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 allowances.

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 January 29, 2011. 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 aged liabilities 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 2010, 2009 and 2008 was $2.0 million, $2.1 million and $2.1 million, respectively.

Intangible assets. Other identifiable intangible 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 $22.2 million at January 29, 2011, and $16.0 million at January 30, 2010. Accumulated amortization at January 29, 2011 and January 30, 2010 totaled $24.8 million and $19.3 million, respectively. Amortization expense for 2010, 2009 and 2008, was $5.5 million, $3.7 million and $2.6 million, respectively. Estimated amortization expense in millions for each of the next 5 years is as follows: 2011 - $5.9, 2012 - $5.5, 2013 - $5.0, 2014 - $3.5 and 2015 - $1.4.

Financial instruments. At January 29, 2011, 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 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 to $500,000 for property and general liability and $200,000 for employee medical. The Company's insurance reserve was $10.3 million and $9.0 million on January 29, 2011 and January 30, 2010, respectively. Changes in the reserve during fiscal 2010 were attributable to additional reserve requirements of $47.3 million netted with reserve utilization of $46.0 million.

Stock-based compensation. Effective January 29, 2006, the Company adopted the fair value recognition provisions of FASB ASC 718, "Compensation – Stock Compensation", 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 FASB ASC 718, 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 FASB ASC 718. Results for prior periods have not been restated.

Effective January 29, 2006, the Company elected to adopt the alternative transition method provided in FASB ASC 718 for calculating the income tax effects of stock-based compensation. 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 FASB ASC 718.

FASB ASC 718 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. The impact of adopting FASB ASC 718 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.

Stock-based compensation expense, post adoption of FASB ASC 718, 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.

Income taxes. The Company reports income taxes in accordance with FASB ASC 740, “Income Taxes.” Under FASB ASC 740, 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 (see Note 4 – Income Taxes).

In June 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48 (“FASB ASC 740”), Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement 109. Effective February 4, 2007, we adopted FASB ASC 740, which clarifies the accounting for uncertainties in income taxes recognized in the Company’s financial statements in accordance with FASB ASC 740 by defining the criterion that an individual tax position must meet in order to be recognized in the financial statements. FASB ASC 740 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 (see Note 4 – Income Taxes).

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 comprehensive 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") codified in FASB ASC 715 "Compensation – Retirement Benefits". See Note 9, Commitments and Contingencies, in the Notes to Consolidated Financial Statements for further discussion.

Reclassifications. Certain prior year amounts have been reclassified to conform to the 2010 presentation.

Recent Accounting Pronouncements. In June 2009, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 168, "The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles – a replacement of SFAS No. 162" ("FASB ASC 105"). FASB ASC 105 modifies the GAAP hierarchy by establishing only two levels of GAAP, authoritative and nonauthoritative accounting literature. Effective July 2009, the FASB Accounting Standards Codification ("ASC"), also known collectively as the "Codification", is considered the single source of authoritative U.S. accounting and reporting standards, except for additional authoritative rules and interpretive releases issued by the SEC. The Codification was developed to organize GAAP pronouncements by topic so that users can more easily access authoritative accounting guidance. FASB ASC 105 became effective for the third quarter of fiscal year 2009. All other accounting standards references have been updated in this report with ASC references.

NOTE 2 – DETAIL OF CERTAIN BALANCE SHEET ACCOUNTS

	(in thousands)	
	2010	2009
Property and equipment, at cost:		
Buildings and building improvements	$ 96,923	$ 95,844
Leasehold improvements	62,504	55,078
Automobiles and vehicles	5,198	5,273
Airplane	4,697	4,697
Furniture, fixtures and equipment	234,710	240,883
	404,032	401,775
Less: Accumulated depreciation and amortization	(271,129)	(271,185)
	132,903	130,590
Construction in progress	198	446
Land	6,830	6,533
Total Property and equipment, at depreciated cost	$ 139,931	$ 137,569

Depreciation expense totaled $23.7 million, $22.7 million and $23.9 million for 2010, 2009 and 2008, respectively.

	(in thousands)	
Other non trade receivables:	2010	2009
Vendor receivables	$ 19,384	$ 14,814
Income tax receivable	3,124	6,762
Franchise stores receivable	1,069	1,334
Coupon receivable	512	357
Insurance claims receivable	26	892
Other	2,263	1,034
Total non trade receivable	$ 26,378	$ 25,193

Prepaid expenses and other current assets:	2010	2009
Prepaid rent	$ 4,161	$ 4,059
Supplies	4,288	3,904
Prepaid advertising	1,425	590
Prepaid insurance	1,274	1,447
Other	2,849	2,392
Total prepaid expenses and other current assets	$ 13,997	$ 12,392

Accrued expenses and other:	2010	2009
Payroll and benefits	$ 14,281	$ 10,454
Insurance reserves	10,252	8,994
Sales and use tax	5,323	5,627
Deferred / contingent rent	2,152	2,507
Warehouse freight and fuel	1,939	1,104
Real estate tax	1,904	1,410
Lease liability	1,473	1,421
Personal property tax	1,118	1,137
Legal settlement and related fees	-	1,521
Other	6,929	5,446
Total accrued expenses and other	$ 45,371	$ 39,621

Other noncurrent liabilities:	2010	2009
Uncertain tax positions	$ 9,285	$ 9,193
Deferred income (see Note 1 - Vendor Rebates and Allowances)	8,110	7,474
Other	491	542
	$ 17,886	$ 17,209

NOTE 3 — INDEBTEDNESS

On September 27, 2010, the Company and Regions Bank entered into the Tenth Loan Modification of the Revolving Loan and Credit Agreement which decreased the credit line from $60 million to $50 million and extended the term until September 27, 2013. All other terms, conditions and covenants remained in place after the amendment, with only a slight modification to one of the financial covenants required by the Agreement. Under the most restrictive covenants of the Agreement, the Company is required to maintain specified shareholders' equity (which was $327.2 million at January 29, 2011) and positive net income levels. The Company was in compliance with all loan covenants at January 29, 2011. Borrowings and the unused fees under the agreement bear interest at a tiered rate based on the Company's previous four quarter average of the Fixed Charge Coverage Ratio. Currently the Company's rates are 112.5 basis points over LIBOR for borrowings and 22.5 basis points over LIBOR for the unused fee. There were no borrowings outstanding under the Agreement at January 29, 2011 and January 30, 2010.

During the second and third quarter of fiscal 2007, the Company acquired the land and buildings, occupied by 7 FRED'S stores which we had previously leased. In consideration for the 7 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 table below shows the long term debt related to these properties due for the next five years as of January 29, 2011:

(dollars in thousands)	2011	2012	2013	2014	2015	Thereafter	Total
Mortgage loans on land & buildings	$ 201	$ 170	$ 1,109	$ 525	$ 520	$ 1,645	$ 4,170

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:

(dollars in thousands)	2010	2009	2008
Current			
Federal	$ 13,808	$ 7,782	$ 12,677
State	1,235	872	671
	15,043	8,654	13,348
Deferred			
Federal	2,070	4,985	(3,478)
State	(172)	947	(602)
	1,898	5,932	(4,080)
	$ 16,941	$ 14,586	$ 9,268

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:

(dollars in thousands)	2010	2009
Deferred income tax assets:		
Accrual for incentive compensation	$ 1,592	$ -
Allowance for doubtful accounts	638	392
Insurance accruals	2,985	2,365
Other accruals	415	496
Net operating loss carryforwards	6,096	5,778
Postretirement benefits other than pensions	293	279
Deferred revenue	785	994
Federal benefit on state reserves	3,044	2,985
Amortization of intangibles	7,020	5,608
Total deferred income tax assets	22,868	18,897
Less: Valuation allowance	2,441	2,123
Deferred income tax assets, net of valuation allowance	20,427	16,774
Deferred income tax liabilities:		
Property, plant and equipment	(16,700)	(15,056)
Inventory valuation	(25,027)	(21,664)
Prepaid expenses	(1,911)	(1,436)
Total deferred income tax liabilities	(43,638)	(38,156)
Net deferred income tax liabilities	$ (23,211)	$ (21,382)

The net operating loss carryforwards are available to reduce state income taxes in future years. These carryforwards total approximately $142.5 million for state income tax purposes and expire at various times during the period 2011 through 2030.

We maintain a valuation allowance for state net operating losses that we do not expect to utilize prior to their expiration. During 2010, the valuation allowance increased $.3 million, and during 2009, the valuation allowance increased $.5 million. 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:

	2010	2009	2008
Income tax provision at statutory rate	35.0 %	35.0 %	35.0 %
Tax credits, principally jobs	(1.0)	(3.6)	(3.8)
State income taxes, net of federal benefit	0.8	1.9	1.3
Permanent differences	0.8	1.2	0.2
Uncertain tax provisions	0.1	3.1	3.4
Change in valuation allowance	0.7	1.4	(0.3)
Other	-	(0.8)	-
Effective income tax rate	36.4 %	38.2 %	35.8 %

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

(in millions)	2010	2009	2008
Beginning balance	$ 9.2	$ 16.5	$ 8.4
Additions for tax position during the current year	0.9	1.0	1.1
Additions for tax positions of prior years	0.3	1.0	7.7
Reductions for tax positions of prior years from lapse of statue	(1.1)	(0.7)	(0.7)
Reductions for settlements of prior year tax positions	-	(8.6)	-
Ending balance	$ 9.3	$ 9.2	$ 16.5

As of January 29, 2010, our liability for unrecognized tax benefits totaled $9.2 million, of which $1.0 million and $0.1 million were recognized as income tax benefit during the periods ending October 31, 2010 and January 29, 2011, respectively, as a result of a lapse in applicable statute of limitations. We had additions of $1.2 million during fiscal 2010, $.9 million of which resulted from state tax positions during the current year. As of January 29, 2011, our liability for unrecognized tax benefits totaled $9.3 million and is recorded in our consolidated balance sheet within “Other noncurrent liabilities,” all of which, if recognized, would affect our effective tax rate. The Company is under examination by state jurisdictions which are expected to be completed within the next 12 months which could result in a change to our unrecognized tax benefits.

FASB ASC 740 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 FASB ASC 740 in the financial statements as a component of income tax expense. As of January 29, 2011, accrued interest and penalties related to our unrecognized tax benefits totaled $1.3 million and $.03 million, respectively. As of January 30, 2010, accrued interest and penalties related to our unrecognized tax benefits totaled $1.4 million and $0.3 million, respectively. Both accrued interest and penalties are 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 2007-2009. 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 fiscal 2029. None of our operating leases contain residual value guarantees. 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 under noncancelable operating leases. Total rent expense under operating leases was $53.4 million, $53.2 million and $54.1 million, for 2010, 2009 and 2008, respectively. Total contingent rentals included in operating leases above was $1.0 million for 2010 and $1.1 million for 2009 and 2008.

Future minimum rental payments under all operating leases as of January 29, 2011 are as follows:

(in thousands)	Operating Leases
2011	$ 46,266
2012	39,852
2013	29,073
2014	19,981
2015	14,032
Thereafter	25,561
Total minimum lease payments	$ 174,765

The gross amount of property and equipment under capital leases was $5.0 million at January 29, 2011 and $5.0 million at January 30, 2010. Accumulated depreciation on property and equipment under capital leases was $5.0 million at January 29, 2011 and January 30, 2010, respectively. We did not incur any depreciation expense on assets under capital lease for 2010 as the assets were fully depreciated. Depreciation expense on assets under capital lease for 2009 and 2008 was $39 thousand and $92 thousand, respectively.

Related Party Transactions

During the year ended January 29, 2011, Atlantic Retail Investors, LLC, which is partially owned by Michael J. Hayes, Chairman of the Board of Directors, owned 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 store leases of the Company. The total rental payments related to these leases were $1.3 million for both years ended January 29, 2011 and January 30, 2010. Total future commitments under related party leases are $7.9 million.

In February 2011, Atlantic Retail Investors, LLC, purchased the land and building occupied by one of Fred's stores, bringing the total related party leases to thirteen. The store was purchased by Atlantic Retail Investors, LLC from an independent landlord/developer. On March 30, 2011, Fred's purchased ten of the thirteen properties leased from Atlantic Retail Investors, LLC, one of which has an additional parcel that is leased to an unrelated party.

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 become dilutive at the time of exercise. The Shareholders Rights Plan was renewed in October 2008 and if unexercised, the Rights will expire in October 2018.

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 February 2, 2008, the Company had 198,813 shares of Class A common stock available to be issued from the March 6, 2002 Registration Statement. On December 31, 2008, the Registration Statement expired and the Company has not elected to renew the 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 January 29, 2011 (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 Plans or Program	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Program
Balance at January 30, 2010				2,830.8
January 31 - February 27, 2010	69.3	$ 9.38	69.3	2,761.5
February 28 - April 3, 2010	-	$ -	-	2,761.5
April 4, - May 1, 2010	-	$ -	-	2,761.5
May 2, - May 29, 2010	-	$ -	-	2,761.5
May 30, - July 3, 2010	-	$ -	-	2,761.5
July 4, - July 31, 2010	222.6	$ 10.43	222.6	2,538.9
August 1, - August 28, 2010	1.1	$ 10.50	1.1	2,537.8
August 29, - October 2, 2010	-	$ -	-	2,537.8
October 3, - October 30, 2010	-	$ -	-	2,537.8
October 31, - November 27, 2011	-	$ -	-	2,537.8
November 28, - January 1, 2011	-	$ -	-	2,537.8
January 2, - January 29, 2011	-	$ -	-	2,537.8

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 1,446,199 shares as of January 29, 2011 (1,631,758 shares as of January 30, 2010) are available to be granted. These options expire five years to seven from the date of grant. Options outstanding at January 29, 2011 expire in fiscal 2011 through fiscal 2018.

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 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 63,680, 60,350 and 73,084 shares issued during fiscal years 2010, 2009 and 2008, respectively. There are 1,410,928 shares approved to be issued under the 2004 Plan and as of January 29, 2011 there were 1,026,833 shares available.

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

(in thousands)	2010	2009	2008
Stock option expense	$552	$789	$526
Restricted stock expense	1,173	573	282
ESPP expense	161	233	182
Total stock-based compensation	$1,886	$1,595	$990
Income tax benefit on stock-based compensation	$509	$364	$228

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:

Stock Options	2010		2009		2008	
Expected volatility	42.1	%	42.5	%	40.1	%
Risk-free interest rate	2.9	%	2.6	%	3.3	%
Expected option life (in years)	5.84		5.84		5.84	
Expected dividend yield	0.7	%	0.6	%	0.5	%
Weighted average fair value at grant date	$5.18		$4.66		$4.53	
Employee Stock Purchase Plan						
Expected volatility	32.3	%	73.2	%	36.8	%
Risk-free interest rate	0.6	%	0.1	%	3.1	%
Expected option life (in years)	0.63		0.63		0.63	
Expected dividend yield	0.6	%	0.4	%	0.4	%
Weighted average fair value at grant date	$2.53		$3.85		$2.48	

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.

Stock Options. The following table summarizes stock option activity from February 2, 2008 through January 29, 2011:

	Options	Weighted-Average Exercise Price	Weighted-Averaged Contractual Life (years)	Aggregate Intrinsic Value (000s)
Outstanding at February 2, 2008	1,216,451	$ 15.40	4.6	$ -
Granted	37,500	10.97		
Forfeited / Cancelled	(114,640)	16.57		
Exercised	(1,200)	13.86		
Outstanding at January 31, 2009	1,138,111	$ 15.13	3.9	$ 11
Granted	404,891	11.26		
Forfeited / Cancelled	(281,072)	15.06		
Exercised	(600)	13.25		
Outstanding at January 30, 2010	1,261,330	$ 13.91	3.1	$ 73
Granted	51,352	12.55		
Forfeited / Cancelled	(384,000)	17.98		
Exercised	(10,220)	12.69		
Outstanding at January 29, 2011	918,462	$ 12.15	3.2	$ 1,524
Exercisable at January 29, 2011	575,433	$ 12.83	2.4	$ 683

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. As of January 29, 2011, total unrecognized stock-based compensation expense net of estimated forfeitures related to non-vested stock options was approximately $.52 million, which is expected to be recognized over a weighted average period of approximately 3.1 years.

Other information relative to option activity during 2010, 2009 and 2008 is as follows:

(dollars in thousands)	2010	2009	2008
Total fair value of stock options vested	$ 792	$ 1,249	$ 2,240
Total pretax intrinsic value of stock options exercised	$ 11	$ -	$ 1

The following table summarizes information about stock options outstanding at January 29, 2011:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Shares	Weighted-Averaged Contractual Life (years)	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
$ 8.66 - $13.25	693,410	3.7	$ 11.19	381,533	$ 11.60

$13.29 - $16.70	188,552	1.6	$ 14.50	157,400	$ 14.59
$16.90 - $27.81	36,500	0.6	$ 18.14	36,500	$ 18.14
	918,462			575,433	

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 February 2, 2008 through January 29, 2011:

	Options	Weighted-Average Grant Date Fair Value
Non-vested Restricted Stock at February 2, 2008	285,635	$ 13.83
Granted	124,653	9.84
Forfeited / Cancelled	(45,876)	14.15
Exercised	(11,628)	13.31
Non-vested Restricted Stock at January 31, 2009	352,784	$ 12.39
Granted	58,993	12.38
Forfeited / Cancelled	(29,909)	13.88
Exercised	(35,358)	14.90
Non-vested Restricted Stock at January 30, 2010	346,510	$ 12.01
Granted	168,736	13.44
Forfeited / Cancelled	(22,208)	11.09
Exercised	(20,111)	11.57
Non-vested Restricted Stock at January 29, 2011	472,927	$ 12.55

The aggregate pre-tax intrinsic value of restricted stock outstanding as of January 29, 2011 is $6.3 million with a weighted average remaining contractual life of 4.4 years. The unrecognized compensation expense net of estimated forfeitures, related to the outstanding restricted stock is approximately $3.1 million, which is expected to be recognized over a weighted average period of approximately 6.2 years. The total fair value of restricted stock awards that vested for the years ended January 29, 2011, January 30, 2010 and January 31, 2009 was $.2 million, $.5 million and $.2 million, respectively.

There were no significant modifications to the Company's share-based compensation plans during fiscal 2010.

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 a participating security and is therefore included in the computation of basic earnings per share.

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 222,552, 1,088,845 and 1,115,611 such options outstanding at January 29, 2011, January 30, 2010 and January 31, 2009.

NOTE 9 — COMMITMENTS AND CONTINGENCIES

Commitments. The Company had commitments approximating $10.5 million at January 29, 2011 and $8.8 million at January 30, 2010 on issued letters of credit, which support purchase orders for merchandise. Additionally, the Company had outstanding letters of credit aggregating approximately $11.0 million at January 29, 2011 and $11.1 million at January 30, 2010 utilized as collateral for its risk management programs.

Salary reduction profit sharing plan. The Company has defined contribution profit sharing plans for the benefit of qualifying employees who have completed three months of service and attained the age of 21. Participants may elect to make contributions to the plans up to 60% of their compensation or a maximum of $16,500. 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 2010, 2009 and 2008, were $.2 million, $.4 million and $.3 million, 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.

Effective February 3, 2007, the Company began recognizing the funded status of its postretirement benefits plan in accordance with SFAS No. 158 codified in FASB ASC 715. In accordance with FASB ASC 715 the Company is required to display the net over-or–underfunded 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 shareholders' equity.

During 2008, the Company changed its measurement date from November 30 to January 31. In accordance with FASB ASC 715, we used the "14-month method" to transition to the new measurement date and calculate the net periodic postretirement benefit cost for the year ended January 31, 2009. As part of the transition, an adjustment to retained earnings was recorded for the two month period December 2, 2008 through January 31, 2009.

The Company's change in benefit obligation based upon an actuarial valuation is as follows:

(in thousands)	January 29, 2011	January 30, 2010	January 31, 2009
Benefit obligation at beginning of year	$542	$396	$539
Service cost	18	33	25
Interest cost	25	30	24
Actuarial loss (gain)	(54)	111	(172)
Benefits paid	(39)	(28)	(28)
Adjustments due to adoption of FASB ASC 715 measurement date provisions	-	-	8
Benefit obligation at end of year	$492	$542	$396

The Company's components of net accumulated other comprehensive income were as follows:

(in thousands)	January 29, 2011	January 30, 2010	January 31, 2009
Accumulated other comprehensive income	$1,372	$1,418	$1,637
Deferred tax	(500)	(514)	(574)
Accumulated other comprehensive income, net	$872	$904	$1,063

The medical care cost trend used in determining this obligation is 7.7% at January 29, 2011, decreasing annually throughout the actuarial projection period. 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	
(in thousands)	January 29, 2011	January 30, 2010
Effect of health care trend rate		
1% increase effect of accumulated benefit obligations	$ 39	$ 52
1% increase effect on periodic cost	4	7
1% decrease effect on accumulated benefit obligations	(35)	(47)
1% decrease effect on periodic cost	(4)	(6)

The discount rate used in calculating the obligation was 4.8% in 2010 and 5.6% in 2009.

The annual net postretirement cost is as follows:

(in thousands)	For the Year Ended January 29, 2011	January 30, 2010	January 31, 2009
Service cost	$18	$33	$25
Interest cost	25	30	24
Amorization of prior service cost	(14)	(14)	(14)
Amorization of unrecognized prior service costs	(87)	(94)	(102)
Net periodic postretirement benefit cost	$(58)	$(45)	$(67)

The Company's policy is to fund claims as incurred.

Information about the expected cash flows for the postretirement medical plan follows:

(in thousands)	Postretirement Medical Plan
Expected Benefit Payments, net of retiree contributions	
2011	$ 41
2012	41
2013	44
2014	46
2015	44
Next 5 years	241

Litigation. In December 2008, a lawsuit entitled Whiteaker, et al v. FRED'S Stores of Tennessee, Inc., et al, was filed in the United States District Court in the Northern District of Mississippi, in which the plaintiffs allege past and future damages as a result of a 2006 trip and fall accident at a Fred's store. The Company denied liability and vigorously defended the case on its merits. In accordance with FASB ASC 450, "Contingencies", the Company did not feel that a loss in this matter was probable or could be reasonably estimated. However, on November 17, 2010, a jury rendered a $1.1 million verdict and apportioned the Company with 81% fault. This case is covered by the Company's General Liability insurance, which has a $250 thousand deductible. The Company is discussing all of its options, including, post-trial options and appeals. On or about February 4, 2011, the trial judge set aside a verdict amount as being excessive but left in effect the percentage of fault and ordered a new trial on damages only.

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, but the court has not 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 FASB ASC 450, "Contingencies", the Company does not feel that a loss in this matter is probable or can be reasonably estimated. Therefore, we have not recorded a liability for this case.

In August 2007, a lawsuit entitled Julia Atchinson, et al. v. FRED'S Stores of Tennessee, Inc., et al, was filed in the United States District Court for the Northern District of Alabama, Southern Division in which the plaintiff alleged 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 sought to recover overtime pay, liquidated damages, attorney's fees and court costs. Although the Company continues to believe that its assistant store managers are and have been properly classified as exempt employees under FLSA and that the matter was not appropriate for collective action treatment, the parties agreed to mediate this case in January 2009 and did so successfully, reaching a settlement of $1.5 million (including attorneys' fees and costs). The court approved the settlement and the Company subsequently paid it in August 2010. Based on the substantial costs of continuing litigation, unfavorably high jury verdicts against other retailers and the constant distraction to management of a possible protracted jury trial, we believe that this is a favorable settlement for FRED'S. FRED'S has admitted no liability or wrongdoing, and no liability or wrongdoing has been found against the Company.

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.

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 January 29, 2011, all of the Company's operations were located within the United States. The following data is presented in accordance with FASB ASC 280, "Segment Reporting."

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

	For the Year Ended					
	January 29, 2011		January 30, 2010		January 31, 2009	
Pharmaceuticals	34.1	%	33.5	%	31.7	%
Household Goods	24.1	%	23.4	%	24.8	%
Food and Tobacco Products	16.2	%	16.2	%	15.5	%
Paper and Cleaning Supplies	8.6	%	9.2	%	9.2	%
Apparel and Linens	7.6	%	7.9	%	8.6	%
Health and Beauty Aids	7.4	%	7.6	%	8.0	%
Sales to Franchised Fred's Stores	2.0	%	2.2	%	2.2	%
Total Sales Mix	100.0	%	100.0	%	100.0	%

NOTE 11 – EXIT AND DISPOSAL ACTIVITY

During fiscal 2007, the Company closed 17 underperforming stores.

During fiscal 2008, the Company closed 74 underperforming stores and 23 underperforming 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 previous 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 fiscal 2009, the Company closed 9 underperforming stores, which is consistent with our anticipated amount of annual store closures in the normal course of business. Therefore, store closures of this nature in this and future years are not deemed exit and disposal related activities.

Inventory Impairment

During fiscal 2007, we recorded a below-cost inventory adjustment of approximately $10.0 million to reduce the value of inventory to lower of cost or market in stores that were planned for closure as part of the Company's strategic plan to improve profitability and operating margin. The adjustment was recorded in cost of goods sold in the consolidated statement of income for the year ended February 2, 2008.

In fiscal 2008, we recorded an additional below-cost inventory adjustment of $0.3 million to reduce the value of inventory to lower of cost or market associated with stores closed in the third quarter and utilized the entire $10.3 million impairment.

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 FASB ASC 420, “Exit or Disposal Cost Obligations.” 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 FASB ASC 420. 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, we closed 17 underperforming 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 year 2008.

During fiscal 2008, we closed 74 underperforming 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 $7.7 million during the period, leaving $3.4 million in the reserve at January 31, 2009.

During fiscal 2009, we reserved an additional $0.1 million in rent expense related to the 9 store closings. We utilized $2.4 million during the period, leaving $1.1 million in the reserve at January 30, 2010.

During fiscal 2010, we reserved an additional $0.6 million in rent expense related to the revision of the estimated amount of the remaining lease liability for the fiscal 2008 and 2009 store closures. We also utilized $1.0 million, leaving $.7 million in the reserve at January 29, 2011.

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

	Beginning Balance January 30, 2010	Additions FY10	Utilized FY10	Ending Balance January 29, 2011
Lease contract termination liability	$ 1.1	$ 0.6	$ (1.0)	$ 0.7

Fixed Asset Impairment

During the fourth quarter of 2007, the Company recorded 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 2008. During the second quarter of fiscal 2008, the Company recorded an additional charge of $.1 million associated with store closures that occurred in the third quarter. Impairment of $0.2 million for the planned store closures was recorded in 2009.

NOTE 12 – QUARTERLY FINANCIAL DATA (UNAUDITED)

The Company's unaudited quarterly financial information for the fiscal years ended January 29, 2011 and January 30, 2010 is reported below:

(in thousands)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Year ended January 29, 2011				
Net sales	$ 471,647	$ 449,467	$ 435,008	$ 485,633
Gross profit	136,949	125,936	129,747	134,386
Net income	8,191	4,958	7,818	8,620
Net income per share				
Basic	$ 0.21	$ 0.13	$ 0.20	$ 0.22
Diluted	$ 0.21	$ 0.13	$ 0.20	$ 0.22
Cash dividends paid per share	$ 0.04	$ 0.04	$ 0.04	$ 0.04
Year ended January 30, 2010				
Net sales	$ 458,380	$ 434,214	$ 422,438	$ 473,104
Gross profit	128,977	120,742	122,869	126,649
Net income	8,550	4,240	5,032	5,793
Net income per share				
Basic	$ 0.21	$ 0.11	$ 0.13	$ 0.15
Diluted	$ 0.21	$ 0.11	$ 0.13	$ 0.15
Cash dividends paid per share	$ 0.02	$ 0.03	$ 0.03	$ 0.03

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 and Exchange Act of 1934, as amended (15 U.S.C 78 et seq.) (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 Exchange Act 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) 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 Exchange Act. 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 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 January 29, 2011. 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 January 29, 2011.

Our independent registered public accounting firm has issued an audit report on our internal controls over financial reporting, which is included in this Form 10-K.

(c) Changes in Internal Control over Financial Reporting. There have been no changes during the year ended January 29, 2011 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 January 29, 2011, 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 report, "Item 9A(b), Management's Annual 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.

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, FRED's, Inc. maintained, in all material respects, effective internal control over financial reporting as of January 29, 2011, 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 January 29, 2011 and January 30, 2010, 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 January 29, 2011 and our report dated April 14, 2011 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

Memphis, Tennessee
April 14, 2011

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:

	Age	Postions and Offices
Michael J. Hayes (1)	69	Director, Chairman of the Board
John R. Eisenman (1)	69	Director
Roger T. Knox (1)	73	Director
Thomas H. Tashjian(1)	56	Director
B. Mary McNabb (1)	62	Director
Michael T. McMillan (1)	51	Director
Bruce A. Efird (1)	51	Director, Chief Executive Officer and President
Jerry A. Shore	58	Executive Vice President, Chief Financial Officer and Chief Administative Officer
Rick A. Chambers	47	Executive Vice President – Pharmacy Operations
Charles S. Vail	68	Corporate Secretary, Senior Vice President – Legal Services and General Counsel
Reggie E. Jacobs	41	Executive Vice President - Corporate Services, Distribution and Transportation
Earl L. Taylor	61	Executive Vice President - Store Operations
Alan C. Crockett	42	Executive Vice President - General Merchandise Manager
Kirby M. Salgado	45	Executive Vice President - General Merchandise Manager

1 Seven directors, constituting the entire Board of Directors, are to be elected at the 2011 Annual Meeting to serve one year or until their successors are elected.

Michael J. Hayes served as Managing Director of the Company from October 1989 until March 2002 when he was elected Chairman of the Board. He was the Chief Executive Officer from October 1989 through January 2009. 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 Zoo 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 its 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 The Plough Foundation.

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. Most recently she served as Chief Executive Officer for Kid's Outlet in California. She has served as a member of the Board of Directors of C-ME (Cyber Merchants Exchange), a public company. 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 Franchise Development for Pepsi-Cola North America, a Division of PepsiCo, where he has spent the last 25 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 and became Chief Executive Officer effective February 1, 2009. 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.

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.

Reggie E. Jacobs was named Executive Vice President – Corporate Services, Distribution and Transportation in August of 2008. Prior to this Mr. Jacobs served as SVP of Distribution, CIO and Director of DC Systems. Prior to joining the company Mr. Jacobs was employed by Dollar General from 1994 to 1998 and by Wal-Mart from 1992 to 1994. Mr. Jacobs holds a B.A from the University of Oklahoma.

Earl L. Taylor has served the Company for over 40 years and was promoted to Executive Vice President - Store Operations in 2008. Mr. Taylor began his retail career with the Company in 1968 as a manager trainee and has served in a variety of positions since including store manager from 1971 to 1979, District Manager from 1979 to 1998, Director of Store Operations from 1998 to 2001 and Regional Vice President from 2001 to 2008.

Alan C. Crockett was named Executive Vice President - General Merchandise Manager in November 2010. Mr. Crockett joined the Company in 2004 and held the position of Senior Vice President – Finance prior to his promotion. Before joining Fred's, he held various management positions with Aerospace Products International from 1999 to 2004, Thomas & Betts from 1997 to 1999 and Wang's International from 1991- to 1997.

Kirby M. Salgado was named Executive Vice President - General Merchandise Manager in November 2010. Mr. Salgado joined the Company in 2008 as the Senior Vice President - Divisional Merchandise Manager of Hardlines, Business Development and Sourcing. He began his retail career in 1990 as a Buyer with Macy's, Inc., one of the nation's premier retailers, and then served in various management positions with Office Depot, Inc. from 1999 to 2008.

The remainder of the information required by this item is incorporated herein by reference to the proxy statement for our fiscal 2010 Annual Meeting.

ITEM 11: Executive Compensation

Information required by this item is incorporated herein by reference to the proxy statement for our 2011 Annual Meeting.

ITEM 12: Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information required by this item is incorporated herein by reference to the proxy statement for our 2011 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 2011 Annual Meeting.

ITEM 14. Principal Accountant Fees and Services

Information required by this item is incorporated herein by reference to the proxy statement for our 2011 Annual Meeting.

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 USA, 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 Articles of Amendment to the Charter of Fred's Inc. [incorporated herein by reference to Exhibit 3.1 to the registration statement on Form 8-A as filed with the SEC on October 17, 2008 (SEC File No. 001-14565) (the "Form 8-A")].

3.3 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].

4.3 Rights Agreement, dated as of October 10, 2008, between Fred's Inc. and Regions Bank [incorporated herein by reference to Exhibit 4.1 to the Form 8-A].

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].

***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 Ninth Modification Agreement of the Revolving Loan and Credit Agreement" dated September 16, 2008 (modifies the Revolving Loan and Credit Agreement dated April 3, 2000.)

*10.23 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].

*10.24 Amendment to Employment Agreement, dated December 22, 2008, between the Company and Bruce A. Efird [incorporated herein by reference to the Company's Form 8-K filed on December 16, 2008].

*10.25 Amendment to Employment Agreement, dated February 16, 2009, between the Company and Bruce A. Efird [incorporated herein by reference to the Company's Form 8-K filed on February 20, 2009].

*10.26 Amendment to Employment Agreement, dated December 16, 2008, between the Company and Michael J. Hayes [incorporated herein by reference to the Company's Form 8-K filed on December 23, 2008].

10.27	Tenth Modification Agreement of the Revolving Loan and Credit Agreement" dated September 27, 2010 (modifies the Revolving Loan and Credit Agreement dated April 3, 2000.)
**21.1	Subsidiaries of Registrant
**23.1	Consent of BDO USA, 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 Executive 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 000-19288)

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
FRED'S, Inc.
Memphis, Tennessee

The audits referred to in our report dated April 14, 2011 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 schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ BDO USA, LLP
Memphis, Tennessee
April 14, 2011

Schedule II — Valuation and Qualifying Accounts

(dollars in thousands)	Beginning Balance	Additions Charged to Costs and Expenses	Deductions and Reclass Adjustments	Ending Balance
Deducted from applicable assets:				
Allowance for doubtful accounts				
Year ended January 29, 2011	$ 764	$ 665	$ 211	$ 1,218
Year ended January 30, 2010	$ 885	$ 636	$ 757	$ 764
Year ended January 31, 2009	$ 879	$ 486	$ 480	$ 885
Inventory valuation reserves				
Year ended January 29, 2011	$ -	$ -	$ -	$ -
Year ended January 30, 2010	$ -	$ -	$ -	$ -
Year ended January 31, 2009	$ 10,025	$ 280	$ 10,305	$ -
Insurance reserves				
Year ended January 29, 2011	$ 8,994	$ 47,250	$ 45,992	$ 10,252
Year ended January 30, 2010	$ 8,633	$ 44,568	$ 44,207	$ 8,994
Year ended January 31, 2009	$ 8,186	$ 40,304	$ 39,857	$ 8,633

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 14th day of April, 2011.

FRED'S, INC.

By:	/s/ Bruce A. Efird Bruce A. Efird, Chief Executive Officer and President
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 14th day of April, 2011.

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