

2011 ANNUAL REPORT

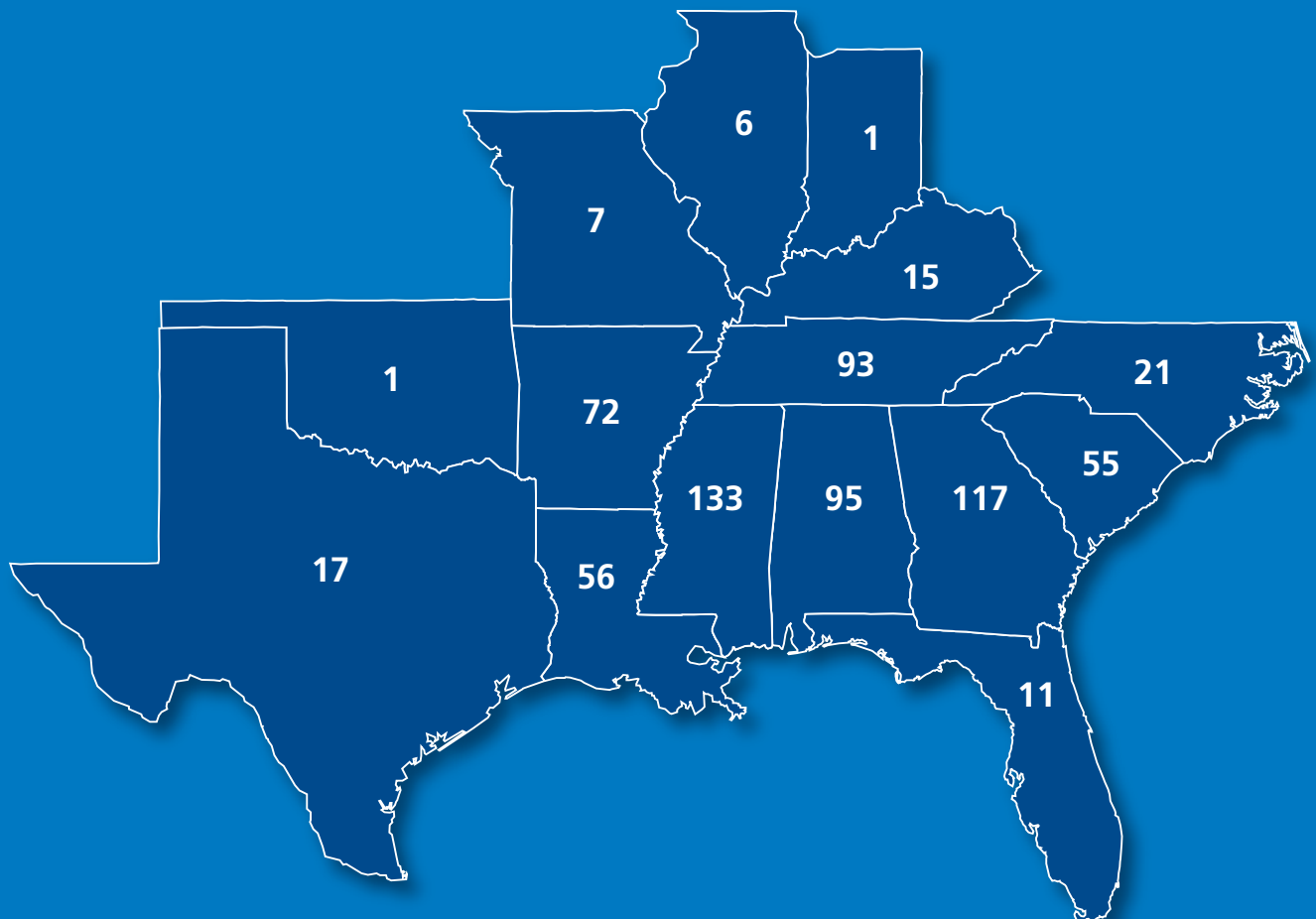


COMPANY PROFILE

Founded in 1947, Fred's operates 700 discount general merchandise stores, including 21 franchised Fred's stores, mainly in the southeastern states. Fred's stores stock more than 12,000 frequently purchased items that address the everyday needs of its customers, including nationally recognized brand name products, proprietary Fred's label products, and lower-priced, off-brand products. The Company is headquartered in Memphis, Tennessee.

NUMBER OF COMPANY-OWNED AND FRANCHISED STORES BY STATE

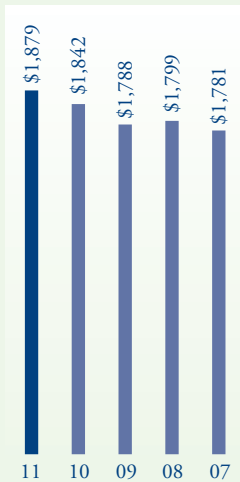
(As of January 28, 2012)



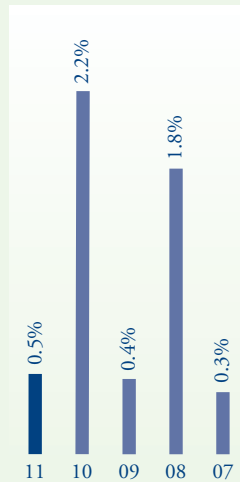
FINANCIAL HIGHLIGHTS

	Years Ended	
	January 28, 2012	January 29, 2011
<i>(\$ in thousands, except per share amounts)</i>		
Operating Data		
Net sales	\$ 1,879,059	\$ 1,841,755
Operating income	51,155	46,718
Net income	33,428	29,587
Net income per share - diluted	0.87	0.75
Weighted average shares outstanding - diluted	38,268	39,196
Cash dividends declared per share	0.20	0.16
Balance Sheet Data		
Working capital	\$ 259,008	\$ 282,097
Total assets	631,982	595,528
Long-term debt (including capital leases)	6,640	3,969
Shareholders' equity	423,612	423,888
Long-term debt to equity	1.6%	0.9%

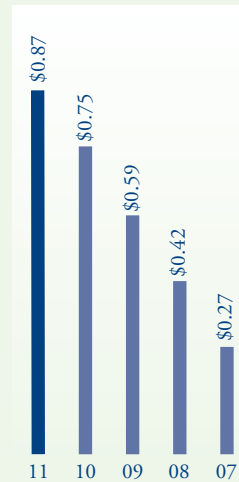
NET SALES
(in millions)



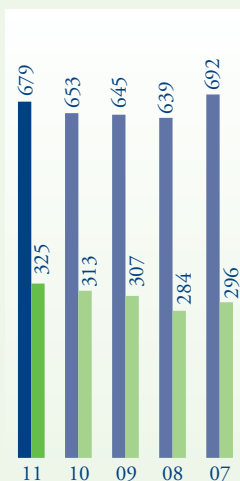
COMPARABLE STORE SALES



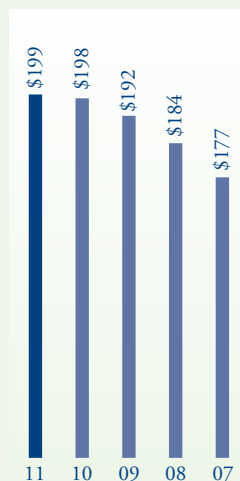
NET INCOME PER SHARE-DILUTED



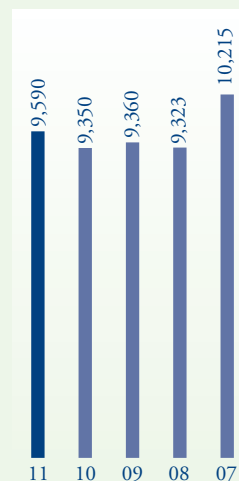
NUMBER OF COMPANY-OWNED STORES
(end of period)



SALES PER SQUARE FOOT



SELLING SPACE (SQUARE FOOTAGE)
(in thousands)



■ Stores
■ Pharmacies

LETTER TO SHAREHOLDERS

I am pleased to provide a fresh update on your company's ongoing progress during 2011. It was another good year for Fred's, and I am extremely proud of the 10,000 team members who contributed to our growth and rose to the challenges of a highly competitive environment. Reflecting their efforts, we continued to execute on our strategic plan, driving sustainable improvements throughout many areas of our business, all of which combined to produce another year of solid earnings growth and generate tangible momentum in our operations.

FINANCIAL REVIEW

Even though the year held some signs of improving economic conditions, those indications were faint and inconsistent across most of our markets, thus we continued to face a generally challenging business climate in 2011. Despite those headwinds, Fred's net income for 2011 increased 16% to \$0.87 per diluted share from \$0.75 per diluted share for 2010 as the Company maintained the upward trajectory that has characterized our operations over the past several years. Total sales for 2011 increased 2% to \$1.879 billion from \$1.842 billion for 2010 and comparable store sales increased 0.5% for 2011 on top of the 2.2% increase we experienced in the year-earlier period. Another notable accomplishment for the year was seen in customer traffic, which again increased 0.7% in 2011.

Gross margin improvement remained a key focus for us in 2011 as we continued to build on our Core 5 program and Own Brand strategies, create new product sourcing opportunities, and reduce costs. These, along with other initiatives, boosted gross margin 10 basis points in 2011 and helped push our operating margin for the year up 20 basis points to 2.7%. As you know, raising our operating margin has been a central objective in our long-term strategic plan.

Just as in 2010, we finished this past year in a very sound financial position, free from operating debt and with a strong cash balance at year's end – a noteworthy feat considering the accelerating growth we experienced with new store and pharmacy openings during 2011, as well as our ongoing investments in store remodels and technology improvements. Because of our continued balance sheet strength and steadfast optimism about Fred's future growth prospects, the Board of Directors again increased the Company's cash dividend rate 25% in 2011, raising the annual payout to \$0.20 per share. The dividend was increased yet again to \$0.24 per share in February 2012. On top of these efforts to drive higher shareholder value, the Company also repurchased almost 2.5 million common shares during 2011 and recently

recharged the stock repurchase program with an additional authorization for another 3.6 million shares.

PHARMACY

There is no question that our pharmacy department is strategic to our long-term objectives. It promotes higher margins and also serves as a proven driver of customer trips and loyalty. In 2011, despite pressure on third-party reimbursements, our pharmacy department results exceeded goals in terms of script growth, unit growth, operating profit, and customer service metrics.

Considering the steady brand-to-generic shift in prescription drugs that we have witnessed during the past several years, we anticipated increased pressure on third-party reimbursements in 2011 from both public and private payers. The actual impact of these pressures was in line with our projections, but the Fred's team managed to overcome these challenges by improving margins in other areas and controlling expenses.

Against this backdrop, we accelerated pharmacy acquisitions again during the past year, utilizing our strong capital position to make 12 pharmacy acquisitions and open 24 new pharmacy locations. The growth in new pharmacies during 2011 enabled us to increase pharmacy department script counts more than 3% last year, successfully expand membership in our Prescription Plus program, and penetrate the immunizations market more deeply.

Looking ahead, we will continue to leverage our pharmacies in 2012. Knowing that third-party margin pressures will continue, we remain optimistic about the future of pharmacy based on our experience that indicates customer loyalty and retention is better in stores with a pharmacy. This stronger customer bond translates into higher front-end traffic, and stores with pharmacies consistently perform on average 10% or more above stores without pharmacies.

We anticipate that the brand-to-generic shift in 2012 will be the most significant in history, as 22% of branded drugs will convert to generic over the next 12 months. Countering this trend, an aging population will drive future script growth and healthcare reform will foster additional pharmacy growth as more individuals gain access to pharmacy benefits coverage. Also, the increasing utilization of home healthcare will benefit pharmacy operations, while our ability to expand clinical services within our pharmacies, such as immunizations, diabetes programs and patient consulting, also will contribute to our pharmacy growth.

MERCHANDISING

During 2011, we continued to make solid headway with our Core 5 program, which focuses on Pharmacy, Celebration and Party, Pet Products, Household Supplies, and Home Products. These key areas drive comparable sales in departments in which Fred's has a clear and marketable advantage over our small-box competitors.

When we conceived the Core 5 program, we recognized that our customers placed great value on both price and selection, and in our testing, the availability of name-brand national products emerged as a key determinant of shopping patterns. After adding important brands to our merchandise line-up in 2010, like Coca-Cola, Purina, and Energizer, we have continued to reinforce our offering with other strong brand names, including Prestone and Sunbeam. We have been encouraged by our customers' response to these efforts.

Our Own Brand initiative continues to be a key element in our strategy for building customer loyalty and increasing gross margin. The strength of this program responds directly to the needs of our customers, considering current economic pressures, and provides an attractive complement to our national brand sales. Additionally, our commitment to quality in our Own Brand products has resonated with customers as we continue to expand our line with new products.

In 2011, we accelerated our growth in store openings by adding 26 new stores, the most in any year since 2007. Also, for the second year in a row, we completed the remodeling and refurbishment of more than 200 stores. At the end of fiscal 2011, approximately 60% of our chain reflected the new look and layout of our current prototype.

CONCLUDING THOUGHTS

In developing our 2012 strategic initiatives, we plan to build on last year's momentum and break new ground in several key areas, with a goal to increase market share, comparable sales, and customer traffic, while driving toward higher operating margins. Expanded marketing efforts in the coming year – more customer-specific and utilizing in-store marketing, direct mailings, and social media – will be a key driver of these efforts. Also, we intend to maintain our price leadership as our customers experience continuing economic pressures.

Based on the improvements we have seen recently in the performance of our new stores, we will continue to invest in store expansion during 2012. We plan to open between 22 and 28 new stores and pharmacies in the coming year. We also will continue to reinvest in our stores with 50 to 75 more remodels and upgrades in 2012. When this year's scheduled upgrades are completed, we will have refreshed or refurbished approximately 70% of our stores over the past three years.

In terms of fundamentals, our team will continue to focus on process improvements and support those with increased investments in technology. These investments will enhance our store operations, provide greater inventory accuracy, and drive higher in-stock levels. Concurrently, we will work to further strengthen operating margins through better product sourcing, improved inventory quality, and leveraging operating expenses throughout the organization.

In closing, 2011 was a very solid year for Fred's as our team made good progress in laying the groundwork for future success. Beyond operational and financial improvements, I was very pleased with the way our team continued to focus on "winning" with our customers, delivering an ever higher standard of service, and fulfilling Fred's vision – *A Smile on Every Customer's Face*.

In 2012, we mark our 65th anniversary as a company and celebrate our role in retail across the Southeast. Fred's also will mark its 20th year as a publicly held company in 2012. Truly, we've come a long way from humble beginnings in 1947 with the opening of our first store in Coldwater, Mississippi, and yet we've never been more excited about the future of Fred's. We believe that there are significant opportunities ahead for stable and consistent growth while extending the improvements in operating performance that we have begun to realize over the past three years. I am confident in the opportunities for Fred's to deliver another year of double-digit earnings growth.

We are grateful for our customers, team members and shareholders. We thank all of you for your support.



Bruce A. Efirid
Chief Executive Officer

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, Consolidated Financial Statements and Notes, and the Forward-Looking Statements/Risk Factors disclosures in Item 1 at our Annual Report on Form 10-K for 2011.

(Dollars in thousands, except per share amounts and store data)

	2011	2010	2009	2008 ²	2007 ²
Statement of Income Data:					
Net sales	\$ 1,879,059	\$ 1,841,755	\$ 1,788,136	\$ 1,798,840	\$ 1,780,923
Operating income	51,155	46,718	38,494	26,318	16,457
Income before income taxes	50,758	46,528	38,201	25,910	15,664
Provision for income taxes	17,330	16,941	14,586	9,268	4,946
Net income	33,428	29,587	23,615	16,642	10,718
Net income per share:					
Basic	\$ 0.88	\$ 0.76	\$ 0.59	\$ 0.42	\$ 0.27
Diluted	0.87	0.75	0.59	0.42	0.27
Cash dividends declared per share	0.20	0.16	0.11	0.08	0.08
Selected Operating Data:					
Operating income as a percentage of sales	2.7%	2.5%	2.2%	1.5%	0.9%
Increase in comparable store sales ¹	0.5%	2.2%	0.4%	1.8%	0.3%
Company owned stores open at end of period	679	653	645	639	692
Balance Sheet Data (at period end):					
Total assets	\$ 631,982	\$ 595,528	\$ 571,441	\$ 544,775	\$ 550,572
Short-term debt (including capital leases)	658	201	718	243	285
Long-term debt (including capital leases)	6,640	3,969	4,179	4,866	35,653
Shareholders' equity	423,612	423,888	400,939	387,081	372,059

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 Item 7: "Results of Operations" section).

² Results include certain charges for the non-routine closing of 75 stores in 2008 and 17 in 2007, (see Item 7: "Exit and Disposal Activities" section) and implementation of ASC 740.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL ACCOUNTING PERIODS

The following information contains references to years 2011, 2010 and 2009, which represent fiscal years ended January 28, 2012, January 29, 2011 and January 30, 2010 (which were 52-week accounting periods). 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 in our Annual Report on Form 10-K for 2011.

EXECUTIVE SUMMARY

Throughout 2011, we continued the implementation of our key initiatives to differentiate our stores from other small-box discount retailers. The Core 5 Program is our long-term strategy 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.

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 direct mail marketing campaign timed to coincide with the refresh of the store and then continuing for six months thereafter. In 2011, we implemented the Core 5 Program in 205 stores, bringing the total completed stores to 413 over the past two years.

As mentioned previously, our Pharmacy department is one of our Core 5 categories and is a key differentiating factor from other small-box discount retailers. As such, 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 acquiring prescription files, but cold starts will be employed where it makes sense to do so. Pharmacy department expansion is a proven driver of customer trips and loyalty. Our stores which have a pharmacy department continue to perform better in general merchandise department sales by over 10% than those without.

During the fourth quarter of fiscal year 2011, we opened sixteen new stores and seven express pharmacy locations. Five express pharmacy locations and one franchise store closed in the quarter. For the fiscal year, there were 26 new stores and ten new express pharmacy locations. Eight stores and two express pharmacy locations were closed during the year. Additionally, three franchise stores closed during the year, bringing the net increase in Fred's locations to 23 for the year.

Another key focus throughout 2011 has been improvement of our store in-stock position. Recognizing in-stock position as one of the fundamental drivers of our business, we have dedicated significant resources to improving the tools we use to monitor and measure in-stock position in our stores. Increased investments in technology played a role in our improvements with implementations in merchandise allocations, price optimization, ad planning, vendor performance tracking, and several business intelligence applications. As an extension of this initiative, we have made significant improvements to our freight flow processes to ensure that product is in the store and available for our customers. Improvements in store in-stock position during the year have been a factor in increasing store sales, as well as improving customer service scores. Improvements being made in the freight flow process will drive higher store in-stock results beyond 2011.

Our Own Brand initiative continues to be a key strategy for the Company in terms of building customer loyalty and increasing gross margin. In 2011, our Own Brand penetration rate was 19.0% of consumable product sales, which is relatively flat with last year. Considering the sales mix shift toward basic and consumable products and the strong increase in national brand sales, we see maintaining our Own Brand penetration rate as a positive during this year. 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 food and health and beauty aids introduced in the last half 2011.

While our private label, or Fred's Brand products, continued to be a focus in 2011, we also carry many national brands in our stores, including products such as Coke, Purina, Energizer, Prestone, and Sunbeam. Our customers identify with these national brands, which provide them with a more complete shopping trip. On an ongoing basis, we will continue to evaluate additional national brands that are the most popular with our customers and will be adding those that complement our current product mix.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Gross margin improvement continues to be a key 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 drive overall product costs down 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 to control shrinkage in our stores and consequently increase gross margin.

During 2011, we used \$66.0 million for capital expenditures and pharmacy acquisitions, a 71% increase over the prior year, with most of the expenditures being used to open new stores and pharmacies, as well as continuing the upgrades of our existing stores. Included in the total is \$3.5 million for technology upgrades such as computer software and hardware, and distribution equipment.

Looking to 2012 and beyond, we expect continuous improvement as we adapt our strategic initiatives to the retail environment for the long-term. We have developed our 2012 strategic initiatives to build on our momentum and break new ground in key areas, with the goal to increase market share, comparable sales, and customer traffic while driving toward higher operating margins. Our Core 5 Program will be an ongoing catalyst for sales growth. Two of our major sales and marketing initiatives going forward are to help the economically challenged customer and attract the younger mother. We will accomplish these initiatives through greater value in basic products, continued expansion of own-brand or private label products, and evolving our Fred's Kids line of products. We will continue to leverage our pharmacy products and service in 2012 as we still view pharmacy growth as a solid use of invested capital. Finally, we will continue to focus on fundamentals and increase investments in technology to drive process improvement and customer satisfaction.

Key factors that will be critical to the Company's future success include the successful roll-out of our Core 5 program, as well as managing the strategy for opening new stores and pharmacies, including the ability to open and operate efficiently, maintaining high standards of customer service, maximizing efficiencies in the supply chain, controlling working capital needs through improved inventory turnover, controlling the effects of inflation 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 2012 include the continuing management of the impacts of the changing regulatory environment in which our pharmacy department operates. Additionally, we believe that the protracted elevation in commodity and fuel prices, as well as the unemployment rate 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 the price conscious consumer.

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 679 Company owned stores and 21 franchised stores as of January 28, 2012. 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.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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 2011, 2010 and 2009 was \$1.8 million, \$2.0 million and \$2.1 million, 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 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. ("U.S. GAAP").

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

The Company calculates inventory losses 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 \$40.4 million, and \$32.5 million at January 28, 2012 and January 29, 2011, 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 \$26.8 million at January 28, 2012 and \$24.0 million at January 29, 2011. The LIFO reserve increased by approximately \$2.8 million and \$2.4 million during 2011 and 2010, respectively.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The Company has historically included an estimate of inbound freight and certain general and administrative costs in merchandise inventory as prescribed by U.S. 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 28, 2012 is \$20.3 million compared to \$19.5 million at January 29, 2011.

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 using a discounted cash flow model.

Exit and Disposal Activities.

Lease Termination

Lease obligations still exist for some store closures that occurred in 2008. We record the estimated future liability associated with the rental obligation on the cease use date (when the stores were closed). The lease obligations 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, "Exit or Disposal Cost Obligations". Key assumptions in calculating the liability include the timeframe expected to terminate lease agreements, estimates related to the sublease potential of closed locations, and estimates 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 2011, we reserved an additional \$0.1 million in rent expense related to the revision of the estimated amount of the remaining lease liability for the fiscal 2008 store closures. We also utilized \$0.5 million, leaving \$0.3 million in the reserve at January 28, 2012.

	Beginning Balance January 29, 2011	Additions FY11	Utilized FY11	Ending Balance January 28, 2012
Lease contract termination liability	\$ 0.7	\$ 0.1	\$ (0.5)	\$ 0.3

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 - 10 years
Airplane	9 years

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

Other identifiable intangible assets, which are included in other noncurrent assets, primarily represent customer lists associated with acquired pharmacies. Based on the Company's history of intangible asset acquisitions beginning in fiscal 2004, these assets are being amortized on a straight-line basis over five years until such time as the Company's internal analysis has sufficient history to indicate another method is preferable.

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 28, 2012, the Company had approximately 1,050 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 2011, 2010 and 2009, were \$21.9 million, \$24.5 million and \$24.0 million, respectively. Gross advertising expenses were reduced by vendor cooperative advertising allowances of \$2.4 million, \$2.4 million and \$2.6 million, for 2011, 2010 and 2009, 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 advertising 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's insurance policy coverage runs August 1 through July 31 of each fiscal year. On August 1, 2011, the Company increased its stop loss limits for excessive or catastrophic claims for general liability to \$350,000 from \$250,000 and for employee medical to \$175,000 from \$150,000. The stop loss limit for worker's compensation remained unchanged at \$500,000. The Company's insurance reserve was \$10.3 million and \$10.3 million on January 28, 2012 and January 29, 2011, respectively. Changes in the reserve over that time period were attributable to additional reserve requirements of \$49.0 million netted with payments of \$49.0 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

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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 28, 2012, accrued interest and penalties related to our unrecognized tax benefits totaled \$1.3 million and \$0.2 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.

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 28, 2012	January 29, 2011	January 30, 2010
Net sales	100.0%	100.0%	100.0%
Cost of good sold ¹	71.3	71.4	72.1
Gross profit	28.7	28.6	27.9
Selling, general and administrative expenses ²	26.0	26.1	25.8
Operating income	2.7	2.5	2.1
Interest expense, net	–	–	–
Income before taxes	2.7	2.5	2.1
Income taxes	0.9	0.9	0.8
Net income	1.8%	1.6%	1.3%

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.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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 2011 COMPARED TO FISCAL 2010

Sales

Net sales for 2011 increased to \$1,879.1 million from \$1,841.8 million in 2010, a year-over-year increase of \$37.3 million or 2.0%. On a comparable store basis, sales for 2011 increased 0.5% (\$9.0 million) compared with a 2.2% (\$33.3 million) increase in the same period last year.

The Company's 2011 front store ("non-pharmacy") sales increased 1.0% over 2010 front store sales. We experienced sales increases in categories such as food, pet, paper and chemical and beverage partially offset by decreases in electronics and home furnishings.

The Company's pharmacy sales were 34.9% of total sales in 2011 compared to 34.1% 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 increased 4.2% over 2010, with third party prescription sales representing approximately 91% 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 21 franchised locations during 2011 declined 3.4% to \$36.1 million (2.0% of sales) compared to fiscal 2010. The decrease in year-over-year franchise sales was due to the impact of three franchise stores that closed during the year as well as 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 34.9% Pharmaceuticals, 23.3% Household Goods, 16.8% Food and Tobacco, 8.7% Paper and Cleaning Supplies, 7.4% Health and Beauty Aids, 6.9% Apparel and Linens, and 2.0% Franchise. The sales mix for the same period last year 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.

For the year, comparable store customer traffic increased 0.7% over last year while the average customer ticket decreased 0.2% to \$19.96.

Gross Profit

Gross profit for the year increased to \$538.5 million in 2011 from \$527.0 million in 2010, a year-over-year increase of \$11.5 million or 2.2%. Gross margin, measured as a percentage of sales, increased to 28.7% in 2011 from 28.6% in 2010, a 10 basis point improvement. Gross margin was favorably impacted by higher pharmacy department rebates.

Selling, General and Administrative Expenses

Selling, general and administrative expenses, including depreciation and amortization, increased to \$487.4 million in 2011 (26.0% of sales) from \$480.3 million in 2010 (26.1% of sales). This 10 basis point expense leveraging resulted primarily from the decrease in advertising costs of \$2.5 million (13 basis points) and an increase in proceeds from the sale of pharmacy script files of \$1.0 million (21 basis points). This leveraging was partially offset by an increase in incentive compensation (18 basis points).

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Operating Income

Operating income increased to \$51.2 million in 2011 (2.7% of sales) from \$46.7 million in 2010 (2.5% of sales) due primarily to an increase in gross profit of \$11.5 million as a result of higher pharmacy department rebates as described in the Gross Profit section above. This favorability was partially offset by an increase in selling, general and administrative expenses of \$7.1 million as described in the Selling, General and Administrative Expenses section above.

Interest Expense, Net

Net interest expense for 2011 totaled \$0.4 million or less than 0.1% of sales compared to \$0.2 million which was also less than 0.1% of sales in 2010. The increase in interest expense was the result of real estate purchases done throughout 2011 that had existing loans that were assumed.

Income Taxes

The effective income tax rate was 34.1% in 2011 compared to 36.4% in 2010. The decrease in the effective tax rate was primarily attributable to the improved utilization of the Work Opportunity Tax Credits, the favorable result of finalized state tax audits and overall favorable state tax rates when compared to the prior year.

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 \$156.6 million for state income tax purposes at January 28, 2012 and expire at various times during 2012 through 2031. 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% to 37% in fiscal 2012.

Net Income

Net income increased to \$33.4 million (\$0.87 per diluted share) in 2011 from \$29.6 million (\$0.75 per diluted share) in 2010, a 13.0% increase. The increase in net income is primarily attributable to the favorable gross profit of \$11.5 million as described in the Gross Profit section above. This favorability was partially offset by the \$7.1 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 \$4.2 million.

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 prior year.

The Company's 2010 front store 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.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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 in 2009 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 2010, comparable store customer traffic increased 0.3% over the prior 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 \$0.2 million or less than 0.1% of sales compared to \$0.3 million which was also less than 0.1% 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.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Net Income

Net income increased to \$29.6 million (\$0.75 per diluted share) in 2010 from \$23.6 million (\$0.59 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.

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 \$259.0 million, \$282.1 million and \$266.7 million at year-end 2011, 2010 and 2009, respectively. Working capital fluctuates in relation to profitability, seasonal inventory levels, and the level of store openings and closings. Working capital at year-end 2011 decreased by \$23.1 million from 2010. The decrease was primarily due to a year-over-year decrease in cash and cash equivalents of \$22.1 million as a result of share repurchases totaling \$28.5 million and \$10.0 million for the acquisition of leased properties. Accounts payable increased \$25.9 million as a result of the increased inventory at year end and improved vendor terms. Partially offsetting the decreased in working capital, inventory increased by \$18.5 million primarily due to inflation and new store growth, and other non-trade receivables increased \$5.7 million primarily from increases in vendor related allowances and income tax receivables. In 2012, the Company intends to open approximately 22-28 stores and pharmacies and close an estimated 10 stores and 5 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 \$76.6 million in 2011, \$42.1 million in 2010 and \$64.2 million in 2009.

In fiscal 2011, accounts payable and accrued expenses increased by approximately \$25.4 million. Deferred income tax expense increased by \$4.6 million and depreciation and amortization increased by \$5.0 million.

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, additional 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 \$0.6 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 \$0.7 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.

Net cash used in investing activities totaled \$62.3 million in 2011, \$38.2 million in 2010 and \$33.2 million in 2009.

Capital expenditures in 2011 totaled \$49.2 million compared to \$27.0 million in 2010 and \$22.7 million in 2009. The capital expenditures during 2011 consisted primarily of existing store improvements (\$19.4 million), the purchase of 17 existing store properties (\$14.5 million), the store and pharmacy expansion program (\$9.6 million), technology (\$3.5 million), and distribution and corporate expenditures (\$2.2 million). Additionally, \$16.8 million was expended related to acquisitions of pharmacies during 2011.

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). Additionally, \$11.5 million was expended related to acquisitions of pharmacies during 2010.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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). Additionally, \$10.7 million was expended related to acquisitions of pharmacies during 2009.

In 2012, the Company is planning capital expenditures totaling approximately \$26.0 million. Expenditures are planned totaling \$18.0 million for new and existing stores and pharmacies. Planned expenditures also include approximately \$5.0 million for technology upgrades and approximately \$3.0 million for distribution center equipment and other capital maintenance. In addition, the Company plans expenditures of approximately \$18.0 million in 2012 for the acquisition of prescription lists and other pharmacy related items.

Net cash used in financing activities totaled \$36.3 million in 2011, \$9.4 million in 2010 and \$11.4 million in 2009.

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 \$0.03 per share to \$0.04 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 \$0.05, a 25 % increase. For the fourth consecutive year, on February 16, 2012, the Board of Directors increased the dividend to shareholders of record as of March 1, 2012 to \$0.06, a 20% 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 2011, the Company repurchased 2,447,823 shares for \$28.5 million compared to 293,000 shares for \$3.0 million in 2010, and 742,663 shares for \$7.2 million in 2009. On February 16, 2012, Fred's Board authorized the expansion of the Company's existing stock repurchase program by increasing the authorization to repurchase an additional 3.6 million shares or approximately 10% of the current outstanding shares.

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 \$423.6 million at January 28, 2012) and positive net income levels. The Company was in compliance with all loan covenants at January 28, 2012. 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 100 basis points over LIBOR for borrowings and 20 basis points over LIBOR for the unused portion of the credit line. There were no borrowings outstanding under the Agreement at January 28, 2012 and January 29, 2011.

Cash and cash equivalents were \$27.1 million at the end of 2011 compared to \$49.2 million at the end of 2010 and \$54.7 million at the end of 2009. 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 2011, 2010 and 2009.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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 28, 2012, which excludes the effect of imputed interest:

<i>(Dollars in thousands)</i>	2012	2013	2014	2015	2016	Thereafter	Total
Operating leases ¹	\$ 49,082	\$ 36,886	\$ 27,334	\$ 21,527	\$ 15,619	\$ 44,102	\$ 194,550
Inventory purchase obligations ²	110,592						110,592
Equipment leases ³	1,689	1,062	945	710	707	210	5,323
Mortgage loans on land & buildings and other ⁴	676	1,307	2,076	998	68	2,195	7,320
Postretirement benefits ⁵	35	38	40	36	37	209	395
Total contractual obligations	\$ 162,074	\$ 39,293	\$ 30,395	\$ 23,271	\$ 16,431	\$ 46,716	\$ 318,180

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 28, 2012.

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 \$10.7 million at January 28, 2012 and \$10.5 million at January 29, 2011 on issued letters of credit, which support purchase orders for merchandise. Additionally, the Company had outstanding standby letters of credit aggregating approximately \$11.2 million at January 28, 2012 and \$11.0 million at January 29, 2011 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

Atlantic Retail Investors, LLC, which is partially owned by Michael J. Hayes, a director of the Company, owned the land and buildings occupied by thirteen Fred's stores, until March 2011 when, as described below, a portion of these properties were purchased by the Company. The terms and conditions regarding the leases on these locations were consistent in all material respects with other stores leases of the Company with unrelated landlords.

On March 30, 2011, Fred's selected and purchased ten of the thirteen properties leased from Atlantic Retail Investors, LLC, one of which has an adjacent parcel and building that is leased to an unrelated party for a total of eleven properties, for \$7.5 million in cash and assumed mortgage debt of \$3.5 million. The Board of Directors approved these transactions after receiving an evaluation by an independent real estate broker, who concluded that all were acquired at comparable, and favorable, purchase prices to market value and were financially beneficial to Fred's as the depreciation expense for the newly acquired assets will be less than the future value of the lease payments that would have been due.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In May 2011 after approximately 18 months of negotiation, Atlantic Retail Investors, LLC purchased the land and building of four additional properties that the Company had previously evaluated multiple times and eventually passed for purchase. These stores were subsequently purchased by Atlantic Retail Investors, LLC, from a lender who had foreclosed on the independent landlord/developer at terms and conditions favorable to those earlier evaluated by the Company. Upon closing, Atlantic Retail Investors, LLC informed the Company of the purchase and offered them at substantially the same terms. The terms and conditions regarding the leases on these locations were consistent or better, in all material respects with other stores leases of the Company with unrelated landlords.

In June 2011, Fred's purchased these four properties together with an adjacent parcel and building at an existing owned location for a total consideration of \$2.4 million in cash. No mortgage debt was assumed in this transaction. The Board of Directors approved these transactions based on the financial terms that were more favorable to market value and financially beneficial to Fred's as a result of the depreciation expense on the newly acquired assets being less than the future value of lease payments that would have been due.

As of January 28, 2012, Fred's is leasing three properties from Atlantic Retail Investors, LLC. The total rental payments for related party leases were \$451.2 thousand for the year ended January 28, 2012 and \$1.3 million for the years ended January 29, 2011 and January 30, 2010, respectively.

RECENT ACCOUNTING PRONOUNCEMENTS

In May 2011, the Financial Accounting Standards Board issued Accounting Standards Update ("ASU") 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U. S. GAAP and IFRSs, which amends the current fair value measurement and disclosure guidance to include increased transparency around valuation inputs and investment categorization. This guidance will be effective beginning in fiscal 2012. The adoption of ASU 2011-04 is not expected to have a material impact on the Company's consolidated net earnings, cash flows or financial position.

In June 2011, the FASB issued ASI 2011-05, Comprehensive Income (Topic 22): Presentation of Comprehensive Income, which revises the current practice of including other comprehensive income within the equity section of the statement of financial position and requires disclosure of other comprehensive income either in a single continuous statement of comprehensive income or in a separate statement. This guidance will be effective beginning in fiscal 2012. The adoption of ASU 2011-05 is not expected to have an impact on the Company's consolidated net earnings, cash flows or financial position, but the adoption will change the current presentation of other comprehensive income in the Company's consolidated financial statements.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company has no holdings of derivative financial or commodity instruments as of January 28, 2012. The Company is exposed to financial market risks, including changes in interest rates. All borrowings under the Company's Revolving Credit Agreement bear interest on a sliding scale from 1.00% - 1.625% plus LIBOR. 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.

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

	For the Years Ended		
	January 28, 2012	January 29, 2011	January 30, 2010
<i>(In thousands, except per share data)</i>			
Net sales	\$ 1,879,059	\$ 1,841,755	\$ 1,788,136
Cost of goods sold	1,340,519	1,314,737	1,288,899
Gross profit	538,540	527,018	499,237
Depreciation and amortization	34,190	29,236	26,387
Selling, general and administrative expenses	453,195	451,064	434,356
Operating income	51,155	46,718	38,494
Interest income	(156)	(234)	(189)
Interest expense	553	424	482
Income before income taxes	50,758	46,528	38,201
Provision for income taxes	17,330	16,941	14,586
Net income	\$ 33,428	\$ 29,587	\$ 23,615
Net income per share			
Basic	\$ 0.88	\$ 0.76	\$ 0.59
Diluted	\$ 0.87	\$ 0.75	\$ 0.59
Weighted average shares outstanding			
Basic	38,176	39,133	39,822
Effect of dilutive stock options	92	63	67
Diluted	38,268	39,196	39,889
Comprehensive income:			
Net income	\$ 33,428	\$ 29,587	\$ 23,615
Other comprehensive income (expense), net of tax postretirement plan adjustment	(8)	(32)	(159)
Comprehensive income	\$ 33,420	\$ 29,555	\$ 23,456

See accompanying notes to condensed consolidated financial statements.

CONSOLIDATED BALANCE SHEETS

<i>(In thousands, except for number of shares)</i>	January 28, 2012	January 29, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 27,130	\$ 49,182
Receivables, less allowance for doubtful accounts of \$1,595 and \$1,218, respectively	31,883	28,146
Inventories	331,882	313,384
Other non-trade receivables	32,090	26,378
Prepaid expenses and other current assets	12,321	12,723
Total current assets	435,306	429,813
Property and equipment, less accumulated depreciation	161,112	139,931
Equipment under capital leases, less accumulated amortization of \$5,043 and \$4,967, respectively	97	–
Intangible assets, net	32,191	22,193
Other noncurrent assets, net	3,276	3,591
Total assets	\$ 631,982	\$ 595,528
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 106,886	\$ 81,002
Current portion of indebtedness	658	201
Accrued expenses and other	44,876	45,371
Deferred income taxes	23,878	21,142
Total current liabilities	176,298	147,716
Long-term portion of indebtedness	6,640	3,969
Deferred income taxes	5,633	2,069
Other noncurrent liabilities	19,799	17,886
Total liabilities	208,370	171,640
Commitments and contingencies (see Note 3 Indebtedness)		
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, 37,203,794 and 39,300,872 shares issued and outstanding, respectively	105,384	131,367
Common stock, Class B nonvoting, no par value, 11,500,000 shares authorized, none outstanding	–	–
Retained earnings	317,364	291,649
Accumulated other comprehensive income	864	872
Total shareholders' equity	423,612	423,888
Total liabilities and shareholders' equity	\$ 631,982	\$ 595,528

See accompanying notes to condensed consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

	Common Stock		Retained Earnings	Accumulated Other Comprehensive	Total
	Shares	Amount		Income	
<i>(In thousands, except share and per share amounts)</i>					
Balance, January 31, 2009	40,028,484	136,877	249,141	1,063	387,081
Cash dividends paid (\$.11 per 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
Cash dividends paid (\$.20 per share)			(7,713)		(7,713)
Restricted stock grants, cancellations and withholdings, net	280,156	(285)			(285)
Issuance of shares under employee stock purchase plan	52,526	571			571
Repurchased and cancelled shares	(2,447,823)	(28,482)			(28,482)
Stock-based compensation		2,075			2,075
Exercises of stock options	18,063	165			165
Income tax benefit on exercise of stock options		(27)			(27)
Adjustment for postretirement benefits (net of tax)				(8)	(8)
Net income			33,428		33,428
Balance, January 28, 2012	37,203,794	\$ 105,384	\$ 317,364	\$ 864	\$ 423,612

See accompanying notes to condensed consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Years Ended		
	January 28, 2012	January 29, 2011	January 30, 2010
<i>(In thousands, except per share data)</i>			
Cash flows from operating activities:			
Net income	\$ 33,428	\$ 29,587	\$ 23,615
Adjustments to reconcile net income to net cash flows from operating activities:			
Depreciation and amortization	34,190	29,236	26,387
Net loss on asset disposition	474	741	356
Provision for store closures and asset impairment	112	340	-
Stock-based compensation	2,075	1,886	1,595
Provision for uncollectible receivables	377	455	(121)
LIFO reserve increase	2,792	2,406	2,411
Deferred income tax expense (benefit)	6,462	1,898	5,932
Income tax benefit upon exercise of stock options	27	10	43
Provision for postretirement medical	(85)	(97)	(74)
(Increase) decrease in operating assets:			
Trade and non-trade receivables	(8,313)	(6,199)	(1,812)
Insurance receivables	205	1,390	(780)
Inventories	(21,402)	(22,106)	5,101
Other assets	607	(1,330)	1,369
Increase (decrease) in operating liabilities:			
Accounts payable and accrued expenses	25,534	(641)	11,593
Income taxes payable	(1,719)	3,813	(7,925)
Other noncurrent liabilities	1,801	668	(3,441)
Net cash provided by operating activities	<u>76,565</u>	<u>42,057</u>	<u>64,249</u>
Cash flows from investing activities:			
Capital expenditures	(45,681)	(27,013)	(22,692)
Proceeds from asset dispositions	119	168	125
Insurance recoveries for replacement assets	-	98	-
Asset acquisitions, net (primarily intangibles)	(16,770)	(11,451)	(10,663)
Net cash used in investing activities	<u>(62,332)</u>	<u>(38,198)</u>	<u>(33,230)</u>
Cash flows from financing activities:			
Payments of indebtedness and capital lease obligations	(514)	(727)	(212)
Excess tax benefit from stock-based compensation	(27)	(10)	(43)
Proceeds from exercise of stock options and employee stock purchase plan	451	595	408
Repurchase of shares	(28,482)	(2,989)	(7,152)
Cash dividends paid	(7,713)	(6,288)	(4,406)
Net cash used in financing activities	<u>(36,285)</u>	<u>(9,419)</u>	<u>(11,405)</u>
Increase (decrease) in cash and cash equivalents	(22,052)	(5,560)	19,614
Cash and cash equivalents:			
Beginning of year	49,182	54,742	35,128
End of year	<u>\$ 27,130</u>	<u>\$ 49,182</u>	<u>\$ 54,742</u>
Supplemental disclosures of cash flow information:			
Interest paid	\$ 397	\$ 190	\$ 293
Income taxes paid	\$ 13,126	\$ 7,145	\$ 22,999
Non-cash investing and financial activities:			
Assets acquired through term loan	\$ 3,497	\$ -	\$ -
Restricted stock issued for the acquisition of intangible assets	\$ 135	\$ 200	\$ -

See accompanying notes to condensed 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 is the sale of general merchandise through its retail discount stores and full service pharmacies. In addition, the Company sells general merchandise to its 21 franchisees. As of January 28, 2012, the Company had 700 retail stores and 325 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 2011, 2010 and 2009, as used herein, refer to the years ended January 28, 2012, January 29, 2011 and January 30, 2010, respectively. The fiscal years 2011, 2010 and 2009 each had 52 weeks.

Use of estimates. The preparation of financial statements in accordance with U.S. GAAP 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 method for goods in our stores and the cost first-in, first-out 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. 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 under the retail inventory method is based on estimates such as markups, markdowns and inventory losses, 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 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company calculates inventory losses 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 \$40.4 million and \$32.5 million at January 28, 2012 and January 29, 2011, respectively, cost was determined using the retail LIFO method in which inventory cost is maintained using the retail inventory method, then adjusted by application of the Producer Price Index published by the U.S. Department of Labor for the cumulative annual periods. The current cost of inventories exceeded the LIFO cost by approximately \$26.8 million at January 28, 2012 and \$24.0 million at January 29, 2011. The LIFO reserve increased by approximately \$2.8 million during 2011 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 U.S. 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 28, 2012 is \$20.3 million, with the corresponding amount of \$19.5 million at January 29, 2011.

The Company did not record any below-cost inventory adjustments during the years ended January 28, 2012, 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:

	<u>Estimated Useful Lives</u>
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 - 10 years
Airplane	9 years

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Assets under capital lease are amortized in accordance with the Company's normal depreciation policy for owned assets or over the lease term (regardless of renewal options), if shorter, and the charge to earnings is included in depreciation expense in the Consolidated Financial Statements. Amortization expense on assets under capital lease for 2011 was \$76 thousand.

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 \$1.0 million at January 28, 2012 and January 29, 2011 respectively, and is included in "Accrued expenses and other" in the consolidated balance sheet (See Note 2 - Detail of Certain Balance Sheet Accounts).

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 property and equipment as well as purchased intangible assets subject to amortization 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 using a discounted cash flow model.

Impairment of \$0.2 million for the planned store closures was recorded in 2009 with no impairments recognized in 2010 or 2011.

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 2011, 2010 and 2009, were \$21.9 million, \$24.5 million and \$24.0 million, respectively. Gross advertising expenses were reduced by vendor cooperative advertising allowances of \$2.4 million, \$2.4 million and \$2.6 million, for 2011, 2010 and 2009, 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 advertising programs.

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

Revenue recognition. The Company markets goods and services through 679 Company owned stores and 21 franchised stores as of January 28, 2012. 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. 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 2011, 2010 and 2009 was \$1.8 million, \$2.0 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 \$32.1 million at January 28, 2012, and \$22.2 million at January 29, 2011. Accumulated amortization at January 28, 2012 and January 29, 2011 totaled \$31.7 million and \$24.8 million, respectively. Amortization expense for 2011, 2010 and 2009, was \$6.9 million, \$5.5 million and \$3.7 million, respectively. Estimated amortization expense in millions for each of the next 5 years is as follows: 2012 - \$8.7 million, 2013 - \$8.1 million, 2014 - \$6.7 million, 2015 - \$4.6 million and 2016 - \$2.4 million.

Financial instruments. At January 28, 2012, 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's insurance policy coverage runs August 1 through July 31 of each fiscal year. On August 1, 2011, the Company increased its stop loss limits for excessive or catastrophic claims for general liability

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

to \$350,000 from \$250,000 and for employee medical to \$175,000 from \$150,000. The stop loss limit for worker's compensation remained unchanged at \$500,000. The Company's insurance reserve was \$10.3 million at January 28, 2012 and January 29, 2011, respectively. Changes in the reserve over that time period were attributable to additional reserve requirements of \$49.0 million netted with payments of \$49.0 million.

Stock-based compensation. The Company uses 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.

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 tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. 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 shareholders' 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 2011 presentation.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Recent Accounting Pronouncements. In May 2011, the Financial Accounting Standards Board issued Accounting Standards Update (“ASU”) 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U. S. GAAP and IFRSs, which amends the current fair value measurement and disclosure guidance to include increased transparency around valuation inputs and investment categorization. This guidance will be effective beginning in fiscal 2012. The adoption of ASU 2011-04 is not expected to have a material impact on the Company’s consolidated net earnings, cash flows or financial position.

In June 2011, the FASB issued ASI 2011-05, Comprehensive Income (Topic 22): Presentation of Comprehensive Income, which revises the current practice of including other comprehensive income within the equity section of the statement of financial position and requires disclosure of other comprehensive income either in a single continuous statement of comprehensive income or in a separate statement. This guidance will be effective beginning in fiscal 2012. The adoption of ASU 2011-05 is not expected to have an impact on the Company’s consolidated net earnings, cash flows or financial position, but the adoption will change the current presentation of other comprehensive income in the Company’s consolidated financial statements.

NOTE 2 – DETAIL OF CERTAIN BALANCE SHEET ACCOUNTS

<i>(In thousands)</i>	January 28, 2012	January 29, 2011
Property and equipment, at cost:		
Buildings and building improvements	\$ 112,321	\$ 96,923
Leasehold improvements	70,509	62,504
Automobiles and vehicles	5,348	5,198
Airplane	4,697	4,697
Furniture, fixtures and equipment	250,241	234,710
	<u>443,116</u>	<u>404,032</u>
Less: Accumulated depreciation and amortization	(289,884)	(271,129)
	<u>153,232</u>	<u>132,903</u>
Construction in progress	23	198
Land	7,857	6,830
Total Property and equipment, at depreciated cost	<u>\$ 161,112</u>	<u>\$ 139,931</u>

Depreciation expense totaled \$27.3 million, \$23.7 million and \$22.7 million for 2011, 2010 and 2009, respectively.

<i>(In thousands)</i>	January 28, 2012	January 29, 2011
Other non-trade receivables:		
Vendor receivables	\$ 22,316	\$ 19,384
Income tax receivable	4,844	3,124
Franchise stores receivable	950	1,069
Coupon receivable	474	512
Insurance claims receivable	201	26
Other	3,305	2,263
Total non trade receivable	<u>\$ 32,090</u>	<u>\$ 26,378</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

<i>(In thousands)</i>	January 28, 2012	January 29, 2011
Prepaid expenses and other current assets:		
Prepaid rent	\$ 4,288	\$ 4,161
Supplies	4,344	4,266
Prepaid insurance	1,842	1,274
Prepaid advertising	413	1,425
Other	1,434	1,597
Total prepaid expenses and other current assets	<u>\$ 12,321</u>	<u>\$ 12,723</u>

<i>(In thousands)</i>	January 28, 2012	January 29, 2011
Accrued expenses and other:		
Payroll and benefits	\$ 13,561	\$ 14,281
Insurance reserves	10,291	10,252
Sales and use tax	5,287	5,323
Deferred / contingent rent	3,599	2,152
Real estate tax	1,612	1,904
Personal property tax	1,177	1,118
Warehouse freight and fuel	564	1,939
Lease liability	478	1,473
Other	8,307	6,929
Total accrued expenses and other	<u>\$ 44,876</u>	<u>\$ 45,371</u>

<i>(In thousands)</i>	January 28, 2012	January 29, 2011
Other noncurrent liabilities:		
Deferred income (see Note 1 - Vendor Rebates and Allowances)	\$ 10,209	\$ 8,110
Uncertain tax positions	9,590	9,285
Other	-	491
	<u>\$ 19,799</u>	<u>\$ 17,886</u>

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 \$423.6 million at January 28, 2012) and positive net income levels. The Company was in compliance with all loan covenants at January 28, 2012. 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 100 basis points over LIBOR for borrowings and 20 basis points over LIBOR for the unused portion of the credit line. There were no borrowings outstanding under the Agreement at January 28, 2012 and January 29, 2011.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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%. On March 30, 2011, Fred's purchased ten properties leased from Atlantic Retail Investors, LLC, one of which has an additional parcel that is leased to an unrelated party, for \$7.5 million in cash and assumed mortgage debt of \$3.5 million on 6 of these locations (see Note 5 – Long-Term Leases) with fixed interest rates from 6.65% 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 28, 2012:

<i>(Dollars in thousands)</i>	2012	2013	2014	2015	2016	Thereafter	Total
Mortgage loans on land & buildings	\$ 676	\$ 1,307	\$ 2,076	\$ 998	\$ 68	\$ 2,195	\$ 7,320

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 for the years ended:

<i>(Dollars in thousands)</i>	2011	2010	2009
Current			
Federal	\$ 9,953	\$ 13,808	\$ 7,782
State	915	1,235	872
	10,868	15,043	8,654
Deferred			
Federal	6,886	2,070	4,985
State	(424)	(172)	947
	6,462	1,898	5,932
	\$ 17,330	\$ 16,941	\$ 14,586

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

<i>(Dollars in thousands)</i>	2011	2010
Deferred income tax assets:		
Accrual for incentive compensation	\$ 111	\$ 1,592
Allowance for doubtful accounts	794	638
Insurance accruals	2,802	2,985
Other accruals	186	415
Net operating loss carryforwards	6,722	6,096
Postretirement benefits other than pensions	374	293
Deferred revenue	693	785
Federal benefit on state reserves	3,176	3,044
Amortization of intangibles	8,489	7,020
Total deferred income tax assets	<u>23,347</u>	22,868
Less: Valuation allowance	<u>2,849</u>	2,441
Deferred income tax assets, net of valuation allowance	<u>20,498</u>	<u>20,427</u>
Deferred income tax liabilities:		
Property, plant and equipment	(21,945)	(16,700)
Inventory valuation	(26,972)	(25,027)
Prepaid expenses	(1,091)	(1,911)
Total deferred income tax liabilities	<u>(50,008)</u>	<u>(43,638)</u>
Net deferred income tax liabilities	<u>\$ (29,510)</u>	<u>\$ (23,211)</u>

The net operating loss carryforwards are available to reduce state income taxes in future years. These carry-forwards total approximately \$156.6 million for state income tax purposes and expire at various times during the fiscal years 2012 through 2031.

We maintain a valuation allowance for state net operating losses that we do not expect to utilize prior to their expiration. During 2011, the valuation allowance increased \$.4 million, and during 2010, the valuation allowance increased \$.3 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:

	2011	2010	2009
Income tax provision at statutory rate	35.0%	35.0%	35.0%
Tax credits, principally jobs	(2.3)	(1.0)	(3.6)
State income taxes, net of federal benefit	(0.2)	0.8	1.9
Permanent differences	0.5	0.8	1.2
Uncertain tax provisions	0.3	0.1	3.1
Change in state valuation allowance	0.8	0.7	1.4
Other	-	-	(0.8)
Effective income tax rate	<u>34.1%</u>	<u>36.4%</u>	<u>38.2%</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

<i>(In millions)</i>	2011	2010	2009
Beginning balance	\$ 9.3	\$ 9.2	\$ 16.5
Additions for tax position during the current year	1.1	0.9	1.0
Additions for tax positions of prior years	0.3	0.3	1.0
Reductions for tax positions of prior years from lapse of statute	(1.1)	(1.1)	(0.7)
Reductions for settlements of prior year tax positions	-	-	(8.6)
Ending balance	<u>\$ 9.6</u>	<u>\$ 9.3</u>	<u>\$ 9.2</u>

As of January 29, 2011, our liability for unrecognized tax benefits totaled \$9.3 million, of which \$0.5 million and \$0.6 million were recognized as income tax benefit during the periods ending October 29, 2011 and January 28, 2012, respectively, as a result of a lapse in applicable statute of limitations. We had additions of \$1.4 million during fiscal 2011, \$1.1 million of which resulted from state tax positions during the current year. As of January 28, 2012, our liability for unrecognized tax benefits totaled \$9.6 million and is recorded in our consolidated balance sheet within "Other noncurrent liabilities," all of which, if recognized, would affect our effective tax rate. Examinations by the state jurisdictions 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 28, 2012, accrued interest and penalties related to our unrecognized tax benefits totaled \$1.2 million and \$0.02 million, respectively. As of January 29, 2011, accrued interest and penalties related to our unrecognized tax benefits totaled \$1.3 million and \$0.3 million, respectively. Both accrued interest and penalties are recorded in the consolidated balance sheet within "Other noncurrent 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 \$53.2 million, \$53.4 million and \$53.2 million, for 2011, 2010 and 2009, respectively. Total contingent rentals included in operating leases above was \$1.0 million for 2011, \$1.0 million for 2010 and \$1.1 million for 2009. Future minimum rental payments under all operating leases as of January 28, 2012 are as follows:

<i>(In thousands)</i>	Operating Leases
2012	\$ 49,082
2013	36,886
2014	27,334
2015	21,527
2016	15,619
Thereafter	44,102
Total minimum lease payments	<u>\$ 194,550</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The gross amount of property and equipment under capital leases was \$5.1 million at January 28, 2012 and \$5.0 million at January 29, 2011. Accumulated amortization on property and equipment under capital leases was \$5.0 million at January 28, 2012 and January 29, 2011, respectively. We did not incur any amortization expense on assets under capital lease for 2010 as the assets were fully amortized. Amortization expense on assets under capital lease for 2011 was \$76 thousand.

Related Party Transactions. Atlantic Retail Investors, LLC, which is partially owned by Michael J. Hayes, a director of the Company, owned the land and buildings occupied by thirteen Fred's stores, until March 2011 when, as described below, a portion of these properties were purchased by the Company. The terms and conditions regarding the leases on these locations were consistent in all material respects with other stores leases of the Company with unrelated landlords.

On March 30, 2011, Fred's selected and purchased ten of the thirteen properties leased from Atlantic Retail Investors, LLC, one of which has an adjacent parcel and building that is leased to an unrelated party for a total of eleven properties, for \$7.5 million in cash and assumed mortgage debt of \$3.5 million. The Board of Directors approved these transactions after receiving an evaluation by an independent real estate broker, who concluded that all were acquired at comparable, and favorable, purchase prices to market value and were financially beneficial to Fred's as the depreciation expense for the newly acquired assets will be less than the future value of the lease payments that would have been due.

In May 2011 after approximately 18 months of negotiation, Atlantic Retail Investors, LLC purchased the land and building of four additional properties that the Company had previously evaluated multiple times and eventually passed for purchase. These stores were subsequently purchased by Atlantic Retail Investors, LLC, from a lender who had foreclosed on the independent landlord/developer at terms and conditions favorable to those earlier evaluated by the Company. Upon closing, Atlantic Retail Investors, LLC informed the Company of the purchase and offered them at substantially the same terms. The terms and conditions regarding the leases on these locations were consistent or better, in all material respects with other stores leases of the Company with unrelated landlords.

In June 2011, Fred's purchased these four properties together with an adjacent parcel and building at an existing owned location for a total consideration of \$2.4 million in cash. No mortgage debt was assumed in this transaction. The Board of Directors approved these transactions based on the financial terms that were more favorable to market value and financially beneficial to Fred's as a result of the depreciation expense on the newly acquired assets being less than the future value of lease payments that would have been due.

As of January 28, 2012, Fred's is leasing three properties from Atlantic Retail Investors, LLC. The total rental payments for related party leases were \$451.2 thousand for the year ended January 28, 2012 and \$1.3 million for the years ended January 29, 2011 and January 30, 2010, respectively

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 28, 2012 (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 29, 2011				2,537.8
January 30 - February 26, 2011	–	\$ –	–	2,537.8
February 27 - April 2, 2011	2.0	\$ 12.50	2.0	2,535.8
April 3, - April 30, 2011	–	\$ –	–	2,535.8
May 1, - May 28, 2011	–	\$ –	–	2,535.8
May 29, - July 2, 2011	256.5	\$ 13.97	256.5	2,279.3
July 3, - July 30, 2011	161.5	\$ 13.84	161.5	2,117.8
July 31, - August 27, 2011	473.4	\$ 11.00	473.4	1,644.4
August 28, - October 1, 2011	1,331.7	\$ 11.21	1,331.7	312.7
October 2, - October 29, 2011	222.7	\$ 11.04	222.7	90.0
October 30, - November 26, 2011	–	\$ –	–	90.0
November 27, - December 31, 2011	–	\$ –	–	90.0
January 1, - January 28, 2012	–	\$ –	–	90.0

On February 16, 2012, Fred's Board authorized the expansion of the Company's existing stock re-purchase program by increasing the authorization to repurchase an additional 3.6 million shares or approximately 10% of the current outstanding shares.

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 1,200,159 shares as of January 28, 2012 (1,446,199 shares as of January 29, 2011) are available to be granted. These options expire five years to seven from the date of grant. Options outstanding at January 28, 2012 expire in fiscal 2012 through fiscal 2019.

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 52,526, 63,680 and 60,350 shares issued during fiscal years 2011, 2010 and 2009, respectively. There are 1,410,928 shares approved to be issued under the 2004 Plan and as of January 28, 2012 there were 974,307 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):

<i>(Dollars in thousands)</i>	2011	2010	2009
Stock option expense	\$ 455	\$ 552	\$ 789
Restricted stock expense	1,446	1,173	573
ESPP expense	174	161	233
Total stock-based compensation	\$ 2,075	\$ 1,886	\$ 1,595
Income tax benefit on stock-based compensation	\$ 573	\$ 509	\$ 364

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	2011	2010	2009
Expected volatility	41.2%	42.1%	42.5%
Risk-free interest rate	1.8%	2.9%	2.6%
Expected option life (in years)	5.13	5.84	5.84
Expected dividend yield	0.9%	0.7%	0.6%
Weighted average fair value at grant date	\$ 4.35	\$ 5.18	\$ 4.66
Employee Stock Purchase Plan			
Expected volatility	27.6%	32.3%	73.2%
Risk-free interest rate	0.3%	0.6%	0.1%
Expected option life (in years)	0.63	0.63	0.63
Expected dividend yield	0.9%	0.6%	0.4%
Weighted average fair value at grant date	\$ 3.32	\$ 2.53	\$ 3.85

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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 January 31, 2009 through January 28, 2012:

	Options	Weighted Average Exercise Price	Weighted Average Contractual Life (Years)	Aggregate Intrinsic Value (Thousands)
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
Granted	113,821	11.96		
Forfeited / Cancelled	(218,844)	14.39		
Exercised	(18,063)	12.12		
Outstanding at January 28, 2012	795,376	\$ 11.52	3.0	\$ 2,831
Exercisable at January 28, 2012	514,457	\$ 11.68	2.3	\$ 1,752

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 28, 2012, total unrecognized stock-based compensation expense net of estimated forfeitures related to non-vested stock options was approximately \$.45 million, which is expected to be recognized over a weighted average period of approximately 3.2 years.

Other information relative to option activity during 2011, 2010 and 2009 is as follows:

<i>(Dollars in thousands)</i>	2011	2010	2009
Total fair value of stock options vested	\$ 642	\$ 792	\$ 1,249
Total pretax intrinsic value of stock options exercised	\$ 42	\$ 11	\$ —

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table summarizes information about stock options outstanding at January 28, 2012:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Shares	Weighted Average Contractual Life (Years)	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
\$ 8.66 - \$13.00	514,317	3.4	\$ 10.44	316,797	\$ 10.54
\$13.02 - \$14.02	234,957	2.3	\$ 13.28	167,840	\$ 13.27
\$14.03 - \$17.35	46,102	2.4	\$ 14.58	29,820	\$ 14.80
	<u>795,376</u>			<u>514,457</u>	

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. If certain performance metrics are met, vesting may be accelerated and is recognized once achievement of the performance metric is considered probable.

The following table summarizes restricted stock from January 31, 2009 through January 28, 2012:

	Options	Weighted Average Grant Date Fair Value
Non-vested Restricted Stock at January 31, 2009	352,784	\$ 12.39
Granted	58,993	12.38
Forfeited / Cancelled	(29,909)	13.88
Exercised	<u>(35,358)</u>	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	<u>(20,111)</u>	11.57
Non-vested Restricted Stock at January 29, 2011	472,927	\$ 12.55
Granted	396,830	3.84
Forfeited / Cancelled	(91,375)	9.02
Exercised	<u>(66,782)</u>	12.17
Non-vested Restricted Stock at January 28, 2012	711,600	\$ 7.74

The aggregate pre-tax intrinsic value of restricted stock outstanding as of January 28, 2012 is \$10.7 million with a weighted average remaining contractual life of 5.1 years. The unrecognized compensation expense net of estimated forfeitures, related to the outstanding restricted stock is approximately \$4.4 million, which is expected to be recognized over a weighted average period of approximately 6.4 years. The total fair value of restricted stock awards that vested for the years ended January 28, 2012, January 29, 2011 and January 30, 2010 was \$0.9 million, \$0.2 million and \$0.5 million, respectively.

There were no significant modifications to the Company's share-based compensation plans during fiscal 2011, 2010 or 2009.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 2,500, 222,552 and 1,088,845 such options outstanding at January 28, 2012, January 29, 2011 and January 30, 2010.

NOTE 9 – COMMITMENTS AND CONTINGENCIES

Commitments. The Company had commitments approximating \$10.7 million at January 28, 2012 and \$10.5 million at January 29, 2011 on issued letters of credit, which support purchase orders for merchandise. Additionally, the Company had outstanding letters of credit aggregating approximately \$11.2 million at January 28, 2012 and \$11.0 million at January 29, 2011 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 \$17,000. 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 2011, 2010 and 2009, were \$0.2 million, \$0.2 million and \$0.4 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. The measurement date for the plan in January 31.

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

<i>(In thousands)</i>	January 28, 2012	January 29, 2011	January 30, 2010
Benefit obligation at beginning of year	\$ 492	\$ 542	\$ 396
Service cost	25	18	33
Interest cost	20	25	30
Actuarial loss (gain)	(33)	(54)	111
Benefits paid	(32)	(39)	(28)
Benefit obligation at end of year	<u>\$ 472</u>	<u>\$ 492</u>	<u>\$ 542</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

<i>(In thousands)</i>	January 28, 2012	January 29, 2011	January 30, 2010
Accumulated other comprehensive income	\$ 1,306	\$ 1,372	\$ 1,418
Deferred tax	(442)	(500)	(514)
Accumulated other comprehensive income, net	\$ 864	\$ 872	\$ 904

The medical care cost trend used in determining this obligation is 7.5% at January 28, 2012, 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:

<i>(In thousands)</i>	For the Year Ended	
	January 28, 2012	January 29, 2011
Effect of health care trend rate		
1% increase effect of accumulated benefit obligations	\$ 40	\$ 39
1% increase effect on periodic cost	5	4
1% decrease effect on accumulated benefit obligations	(36)	(35)
1% decrease effect on periodic cost	(5)	(4)

The discount rate used in calculating the obligation was 3.9% in 2011 and 4.8% in 2010.

The annual net postretirement cost is as follows:

<i>(In thousands)</i>	For the Year Ended		
	January 28, 2012	January 29, 2011	January 30, 2010
Service cost	\$ 25	\$ 18	\$ 33
Interest cost	20	25	30
Amortization of prior service cost	(13)	(14)	(14)
Amortization of unrecognized prior service costs	(85)	(87)	(94)
Net periodic postretirement benefit cost	\$ (53)	\$ (58)	\$ (45)

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

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

<i>(In thousands)</i>	Postretirement Medical Plan
Expected Benefit Payments net of retiree contributions	
2012	\$ 35
2013	38
2014	40
2015	36
2016	37
Thereafter	209

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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", management concluded a loss in the matter was not probable or could not 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. 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. On or about June 20, 2011, the Company, through its insurance carrier, verbally agreed to settle the lawsuit for \$700,000, which was paid in the second quarter of 2011. As a result, on or about July 28, 2011, the Court issued a judgment of dismissal with prejudice.

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 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 remote 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 - "Description of Business and Summary of Significant Accounting Policies" for a brief description of the Company's business. As of January 28, 2012, 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 28, 2012	January 29, 2011	January 30, 2010
Pharmaceuticals	34.9%	34.1%	33.5%
Household Goods	23.3%	24.1%	23.4%
Food and Tobacco Products	16.8%	16.2%	16.2%
Paper and Cleaning Supplies	8.7%	8.6%	9.2%
Health and Beauty Aids	7.4%	7.4%	7.6%
Apparel and Linens	6.9%	7.6%	7.9%
Sales to Franchised Fred's Stores	2.0%	2.0%	2.2%
Total Sales Mix	100.0%	100.0%	100.0%

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 11 – EXIT AND DISPOSAL ACTIVITY

Lease Termination

Lease obligations still exist for some store closures that occurred in 2008. We record the estimated future liability associated with the rental obligation on the cease use date (when the stores were closed). The lease obligations 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, “Exit or Disposal Cost Obligations”. Key assumptions in calculating the liability include the timeframe expected to terminate lease agreements, estimates related to the sublease potential of closed locations, and estimates 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 2011, we reserved an additional \$0.1 million in rent expense related to the revision of the estimated amount of the remaining lease liability for the fiscal 2008 store closures. We also utilized \$0.5 million, leaving \$0.3 million in the reserve at January 28, 2012.

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

<i>(In millions)</i>	Beginning Balance January 29, 2011	Additions FY11	Utilized FY11	Ending Balance January 28, 2012
Lease contract termination liability	0.7	0.1	(0.5)	0.3

NOTE 12 – QUARTERLY FINANCIAL DATA (UNAUDITED)

The Company’s unaudited quarterly financial information for the fiscal years ended January 28, 2012 and January 29, 2011 is reported below:

<i>(In thousands, except per share data)</i>	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Year ended January 28, 2012				
Net sales	\$ 484,399	\$ 452,690	\$ 444,378	\$ 497,592
Gross profit	137,942	126,931	135,966	137,701
Net income	9,514	5,086	9,032	9,796
Net income per share				
Basic	\$ 0.24	\$ 0.13	\$ 0.24	\$ 0.27
Diluted	\$ 0.24	\$ 0.13	\$ 0.24	\$ 0.26
Cash dividends paid per share	\$ 0.05	\$ 0.05	\$ 0.05	\$ 0.05
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

**NOTES TO CONSOLIDATED
FINANCIAL STATEMENTS**

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 28, 2012 and January 29, 2011 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 28, 2012. 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 28, 2012 and January 29, 2011, and the results of its operations and its cash flows for each of the three years in the period ended January 28, 2012, 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 28, 2012, 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 12, 2012 expressed an unqualified opinion thereon.

BDO USA, LLP

Memphis, Tennessee
April 12, 2012

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 28, 2012. 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 28, 2012.

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.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING

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 28, 2012, 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, 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 28, 2012, 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 28, 2012 and January 29, 2011, 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 28, 2012 and our report dated April 12, 2012 expressed an unqualified opinion thereon.

BDO USA, LLP

Memphis, Tennessee
April 12, 2012

DIRECTORS AND OFFICERS

BOARD OF DIRECTORS

Michael J. Hayes

*Chairman of the Board
Fred's, Inc.*

Bruce A. Efirm

*President and Chief Executive Officer
Fred's, Inc.*

John R. Eisenman

*Real Estate Investments
REMAX Island Realty, Inc.
Former President of Sally's, Inc.
(a restaurant chain)
Former commercial real estate developer*

Roger T. Knox

*President Emeritus
Memphis Zoological Society
Former Chairman of the Board and
Chief Executive Officer
Goldsmith's Department Stores
(retailing)*

Michael T. McMillan

*Senior Director of Franchise Development
Pepsi-Cola North America
(consumer products)*

B. Mary McNabb

*Former Chief Executive Officer
Kid's Outlet in California
(retailing)*

Thomas J. Tashjian

Private Investor

EXECUTIVE OFFICERS

Michael J. Hayes

Chairman

Bruce A. Efirm

President and Chief Executive Officer

Jerry A. Shore

*Executive Vice President, Chief Financial Officer and
Chief Administrative Officer*

Rick A. Chambers

Executive Vice President – Pharmacy Operations

Alan C. Crockett

Executive Vice President – General Merchandise Manager

Reggie E. Jacobs

*Executive Vice President – Corporate Services,
Distribution and Transportation*

Kirby M. Salgado

Executive Vice President – General Merchandise Manager

Ricky W. Pruitt

Executive Vice President – Store Operations

Charles S. Vail

*Corporate Secretary, Vice President – Legal Services
and General Counsel*

CORPORATE INFORMATION

CORPORATE OFFICES

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4300 New Getwell Road
Memphis, Tennessee 38118
(901) 365-8880

WEB ADDRESS

www.fredsinc.com

SIC 5331

TRANSFER AGENT

American Stock Transfer & Trust Company
59 Maiden Lane
New York, New York 10038
(800) 937-5449

INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

BDO USA, LLP
Memphis, Tennessee

SECURITIES COUNSEL

Baker, Donelson, Bearman, Caldwell & Berkowitz, P.C.
Memphis, Tennessee

ANNUAL REPORT ON FORM 10-K

Shareholders of record may obtain a copy of the Company's Annual Report on Form 10-K for the year ended January 28, 2012, as filed with the Securities and Exchange Commission, without charge upon written request to Jerry A. Shore, Executive Vice President and Chief Financial Officer. In addition, we make available free of charge through our website at www.fredsinc.com annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports filed with or furnished to the SEC. The reports are available as soon as reasonably practical after we electronically file such material with the SEC, and may be found using the "SEC Filings" link under the "Investor Relations" section of our website.

ANNUAL MEETING OF SHAREHOLDERS

The 2012 annual meeting of shareholders will be held at 5:00 p.m. Eastern Daylight Time on Wednesday, June 19, 2012, at the Holiday Inn Express, 2192 S. Highway 441, Dublin, Georgia. Shareholders of record as of April 20, 2012, are invited to attend this meeting.

MARKET AND DIVIDEND INFORMATION

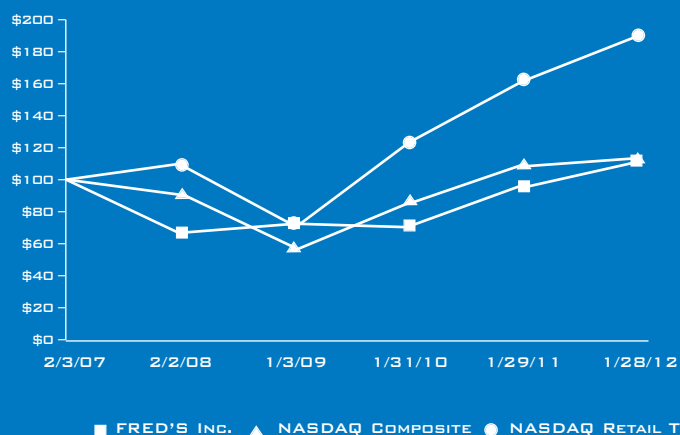
The Company's common stock trades on the NASDAQ Global Select Market under the symbol FRED (CUSIP No. 356108-10-0). At April 20, 2012, the Company had an estimated 18,000 shareholders, including beneficial owners holding shares in nominee or street name.

The table below sets forth the high and low stock prices, together with cash dividends paid per share, for each fiscal quarter in the past two fiscal years.

	High	Low	Dividends Per Share
Fiscal 2011			
Fourth	\$ 15.26	\$ 11.54	\$ 0.05
Third	\$ 13.52	\$ 10.27	\$ 0.05
Second	\$ 14.74	\$ 13.10	\$ 0.05
First	\$ 14.30	\$ 12.02	\$ 0.05
Fiscal 2010			
Fourth	\$ 14.40	\$ 11.70	\$ 0.04
Third	\$ 12.98	\$ 10.36	\$ 0.04
Second	\$ 14.30	\$ 10.16	\$ 0.04
First	\$ 14.39	\$ 9.07	\$ 0.04

The following graph shows a comparison of the cumulative total returns for the past five years. The total cumulative return on investment assumes that \$100 was invested in Fred's on February 3, 2007, and \$100 was invested in the NASDAQ Retail Trade Stocks Index and the NASDAQ Stock Market (U.S.) Index on January 31, 2007, and that all dividends were reinvested.

COMPARISON OF 5-YEAR CUMULATIVE TOTAL RETURN
Among Fred's, Inc., The NASDAQ Composite Index and The NASDAQ Retail Trade Index





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MEMPHIS, TN 38118