FREDS INC
Form 10-Q
June 12, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended May 3, 2014.

OR

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

For the transition period from ________ to ________ .

Commission file number 001-14565

FRED'S, INC.

(Exact name of registrant as specified in its charter)

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

4300 New Getwell Road

Memphis, Tennessee 38118

(Address of Principal Executive Offices)

(901) 365-8880

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer ¨ Accelerated filer x

Non-accelerated filer ¨ Smaller reporting company ¨

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

The registrant had 36,854,915 shares of Class A voting, no par value common stock outstanding as of June 6, 2014.

FRED'S, INC.

INDEX

Part I – FINANCIAL INFORMATION

Item 1. Financial Statements

FRED'S, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except for number of shares)

	May 3, 2014 (unaudited)	February 1, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$ 8,189	$ 6,725
Receivables, less allowance for doubtful accounts of $2,213 and $2,097, respectively	38,835	35,161
Inventories	382,882	361,993
Other non-trade receivables	31,253	37,490
Prepaid expenses and other current assets	13,833	13,245
Total current assets	474,992	454,614
Property and equipment, at depreciated cost	151,051	153,363
Equipment under capital leases, less accumulated amortization of $5,120 and $5,111, respectively	20	29
Intangibles	60,455	54,580
Other noncurrent assets, net	5,243	3,582
Total assets	$ 691,761	$ 666,168
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 141,746	$ 125,925
Current portion of indebtedness	2,062	1,640
Accrued expenses and other	47,413	44,618
Deferred income taxes	24,768	24,446
Total current liabilities	215,989	196,629
Long-term portion of indebtedness	2,231	3,578
Deferred income taxes	-	-
Other noncurrent liabilities	16,911	14,413
Total liabilities	235,131	214,620
Commitments and Contingencies		
Shareholders' equity:		

Preferred stock, nonvoting, no par value, 10,000,000 shares authorized, none outstanding	-	-
Preferred stock, Series A junior participating nonvoting, no par value, 224,594 shares authorized, none outstanding	-	-
Common stock, Class A voting, no par value, 60,000,000 shares authorized, 36,821,837 and 36,791,279 shares issued and outstanding, respectively	103,695	102,524
Common stock, Class B nonvoting, no par value, 11,500,000 shares authorized, none outstanding	-	-
Retained earnings	352,232	348,321
Accumulated other comprehensive income	703	703
Total shareholders' equity	456,630	451,548
Total liabilities and shareholders' equity	$ 691,761	$ 666,168

See accompanying notes to condensed consolidated financial statements.

FRED’S, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(unaudited)

(in thousands, except per share amounts)

	Thirteen Weeks Ended	
	May 3, 2014	May 4, 2013
Net sales	$ 498,264	$ 501,495
Cost of goods sold	355,790	350,476
Gross profit	142,474	151,019
Depreciation and amortization	9,839	10,301
Selling, general and administrative expenses	122,606	122,934
Operating income	10,029	17,784
Interest income	-	-
Interest expense	135	135
Income before income taxes	9,894	17,649
Provision for income taxes	3,776	6,238
Net income	$ 6,118	$ 11,411
Net income per share		
Basic	$ 0.17	$ 0.31
Diluted	$ 0.17	$ 0.31
Weighted average shares outstanding		
Basic	36,606	36,507
Effect of dilutive stock options	228	114
Diluted	36,834	36,621
Dividends per common share	$ 0.06	$ 0.06

FRED’S, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited)

(in thousands)

	Thirteen Weeks Ended	
	May 3, 2014	May 4, 2013
Net income	$ 6,118	$ 11,411
Other comprehensive income (expense), net of tax		
Postretirement plan adjustment	-	-
Comprehensive income	$ 6,118	$ 11,411

See accompanying notes to condensed consolidated financial statements.

FRED'S, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(in thousands)

	Thirteen Weeks Ended	
	May 3, 2014	May 4, 2013
Cash flows from operating activities:		
Net income	$ 6,118	$ 11,411
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation and amortization	9,839	10,301
Net loss on asset disposition	(607)	(213)
Provision (benefit) for store closures and asset impairment	(145)	893
Stock-based compensation	665	576
Provision (recovery) for uncollectible receivables	115	(10)
LIFO reserve increase	617	1,699
Deferred income tax benefit	(1,624)	(800)
Income tax expense (benefit) upon exercise of stock options	(54)	35
Changes in operating assets and liabilities:		
(Increase) decrease in operating assets:		
Trade and non-trade receivables	(27)	1,912
Insurance receivables	-	-
Inventories	(21,361)	(18,622)
Other assets	(408)	76
Increase in operating liabilities:		
Accounts payable and accrued expenses	18,617	3,751
Income taxes payable	2,648	3,484
Other noncurrent liabilities	2,483	3,119
Net cash provided by operating activities	16,876	17,612
Cash flows from investing activities:		
Capital expenditures	(5,210)	(6,854)
Proceeds from asset dispositions	843	715
Asset acquisition, net (primarily intangibles)	(8,419)	(2,397)
Net cash used in investing activities	(12,786)	(8,536)
Cash flows from financing activities:		
Payments of indebtedness and capital lease obligations	(933)	(744)
Proceeds from revolving line of credit	146,970	85,918
Payments on revolving line of credit	(146,962)	(92,893)
Excess tax charges from stock-based compensation	54	(35)
Proceeds from exercise of stock options and employee stock purchase plan	452	548

Repurchase of shares	-	-
Cash dividends paid	(2,207)	(2,204)
Net cash used in financing activities	(2,626)	(9,410)
Increase (decrease) in cash and cash equivalents	1,464	(334)
Cash and cash equivalents:		
Beginning of year	6,725	8,129
End of period	$ 8,189	$ 7,795
Supplemental disclosures of cash flow information:		
Interest paid	$ 135	$ 135
Income taxes paid	$ 2,120	$ 3,144

See accompanying notes to condensed consolidated financial statements.

5

FRED'S, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

NOTE 1: BASIS OF PRESENTATION

Fred's, Inc. and subsidiaries ("Fred's", “We”, “Our”, “Us” or “Company”) operates, as of May 3, 2014, 704 discount general merchandise stores, including 21 franchised Fred's stores, in 15 states in the southeastern United States. There are 359 full service pharmacy departments located within our discount general merchandise stores.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and are presented in accordance with the requirements of Form 10-Q, and therefore, do not include all information and notes necessary for a fair presentation of financial position, results of operations and cash flows in conformity with GAAP. The statements reflect all adjustments (consisting of only normal recurring accruals) which are, in the opinion of management, necessary for a fair presentation of financial position in conformity with GAAP. The statements should be read in conjunction with the Notes to the Consolidated Financial Statements for the fiscal year ended February 1, 2014 incorporated into Our Annual Report on Form 10-K.

The results of operations for the thirteen week period ended May 3, 2014 are not necessarily indicative of the results to be expected for the full fiscal year.

NOTE 2: INVENTORIES

Merchandise inventories are valued at the lower of cost or market using the retail first-in, first-out (FIFO) method for goods in our stores and the cost FIFO method for goods in our distribution centers. The retail inventory method is a reverse mark-up, averaging method which has been widely used in the retail industry for many years. This method calculates a cost-to-retail ratio that is applied to the retail value of inventory to determine the cost value of inventory and the resulting cost of goods sold and gross margin. The assumptions that the retail inventory method provides for valuation at lower of cost or market and the inherent uncertainties therein are discussed in the following paragraphs. In order to assure valuation at the lower of cost or market, the retail value of our inventory is adjusted on a consistent basis to reflect current market conditions. These adjustments include increases to the retail value of inventory for initial markups to set the selling price of goods or additional markups to adjust pricing for inflation and decreases to the retail value of inventory for markdowns associated with promotional, seasonal or other declines in the market value. Because these adjustments are made on a consistent basis and are based on current prevailing market conditions, they approximate the carrying value of the inventory at net realizable value (market value). Therefore, after applying the cost to retail ratio, the cost value of our inventory is stated at the lower of cost or market as is prescribed by GAAP.

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

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

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 $40.7 million and $40.4 million at May 3, 2014 and February 1, 2014, respectively, cost was determined using the retail last-in, first-out (LIFO) method in which inventory cost is maintained using the retail inventory method, then adjusted by application of the Producer Price Index published by the U.S. Department of Labor for the cumulative annual periods. The current cost of inventories exceeded the LIFO cost by approximately $35.8 million at May 3, 2014 and $35.2 million at February 1, 2014.

The Company has historically included an estimate of inbound freight and certain general and administrative costs in merchandise inventory as prescribed by GAAP. These costs include activities surrounding the procurement and storage of merchandise inventory such as merchandise planning and buying, warehousing, accounting, information technology and human resources, as well as inbound freight. The total amount of procurement and storage costs and inbound freight included in merchandise inventory at May 3, 2014 is $22.8 million, with the corresponding amount of $21.6 million at February 1, 2014.

NOTE 3: STOCK-BASED COMPENSATION

The Company accounts for its stock-based compensation plans in accordance with the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 718 "Compensation – Stock Compensation". Under FASB ASC 718, stock-based compensation expense is based on awards ultimately expected to vest, and therefore has been reduced for estimated forfeitures. Forfeitures are estimated at the time of grant based on the Company's historical forfeiture experience and will be revised in subsequent periods if actual forfeitures differ from those estimates.

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 as required prior to FASB ASC 718. A summary of the Company's stock-based compensation (a component of selling, general and administrative expenses) and related income tax benefit is as follows *(in thousands)*:

	Thirteen Weeks Ended	
	May 3, 2014	May 4, 2013
Stock option expense	$ 202	$ 163
Restricted stock expense	408	361
ESPP expense	55	52
Total stock-based compensation	$ 665	$ 576
Income tax benefit on stock-based compensation	$ 176	$ 159

7

The fair value of each option granted during the thirteen week period ended May 3, 2014 and May 4, 2013 is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Thirteen Weeks Ended			
	May 3, 2014		May 4, 2013	
Stock Options				
Expected volatility	36.9	%	39.2	%
Risk-free interest rate	1.7	%	1.0	%
Expected option life (in years)	5.84		5.84	
Expected dividend yield	1.54	%	1.24	%
Weighted average fair value at grant date	$ 5.37		$ 4.68	
Employee Stock Purchase Plan				
Expected volatility	41.1	%	27.4	%
Risk-free interest rate	0.2	%	0.2	%
Expected option life (in years)	0.25		0.25	
Expected dividend yield	0.45	%	0.45	%
Weighted average fair value at grant date	$ 4.15		$ 2.80	

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

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

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

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

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

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

Employee Stock Purchase Plan

The 2004 Employee Stock Purchase Plan (the “2004 Plan”), which was approved by Fred’s shareholders, 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 12,654 shares issued during the thirteen weeks ended May 3, 2014. There are 1,410,928 shares approved to be issued under the 2004 Plan and as of May 3, 2014, there were 845,911 shares available.

Stock Options

The following table summarizes stock option activity during the thirteen weeks ended May 3, 2014:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (Thousands)
Outstanding at February 1, 2014	1,142,429	$ 12.63	3.0	$ 5,539
Granted	11,500	$ 16.90		
Forfeited / Cancelled	(3,200)	$ 14.21		
Exercised	(30,822)	$ 11.71		
Outstanding at May 3, 2014	1,119,907	$ 12.70	2.8	$ 6,364
Exercisable at May 3, 2014	477,688	$ 10.72	1.3	$ 3,660

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between Fred’s closing stock price on the last trading day of the period ended May 3, 2014 and the exercise price of the option multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on that date. As of May 3, 2014, total unrecognized stock-based compensation expense net of estimated forfeitures related to non-vested stock options was approximately $1.3 million, which is expected to be recognized over a weighted average period of approximately 2.9 years. The total fair value of options vested during the thirteen weeks ended May 3, 2014 was $210.9 thousand.

Restricted Stock

The following table summarizes restricted stock activity during the thirteen weeks ended May 3, 2014:

	Number of Shares	Weighted Average Grant Date Fair Value
Non-vested Restricted Stock at February 1, 2014	551,013	$ 13.53
Granted	48,200	$ 18.99
Forfeited / Cancelled	(57,104)	$ 13.96
Vested	(15,004)	$ 13.24

Non-vested Restricted Stock at May 3, 2014	527,105	$ 13.99

The aggregate pre-tax intrinsic value of restricted stock outstanding as of May 3, 2014 is $9.7 million with a weighted average remaining contractual life of 5.7 years. The unrecognized compensation expense net of estimated forfeitures, related to the outstanding stock is approximately $4.4 million, which is expected to be recognized over a weighted average period of approximately 7.0 years. The total fair value of restricted stock awards that vested during the thirteen weeks ended May 3, 2014 was $198.7 thousand.

NOTE 4 — FAIR VALUE MEASUREMENTS

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy, as defined below, gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.

- Level 1, defined as quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.
- Level 2, defined as inputs other than quoted prices included within Level 1, that are observable for the asset or liability, either directly or indirectly.
- Level 3, defined as unobservable inputs for the asset or liability.

9

Due to their short-term nature, the Company’s financial instruments, which include cash and cash equivalents, receivables and accounts payable, are presented on the Condensed Consolidated Balance Sheet at a reasonable estimate of their fair value as of May 3, 2014 and February 1, 2014. No borrowings on the revolving line of credit existed at the balance sheet date. The fair value of our mortgage loans are estimated using Level 2 inputs based on the Company's current incremental borrowing rate for comparable borrowing arrangements.

The table below details the fair value and carrying values for the mortgage loans as of the following dates:

	May 3, 2014		February 1, 2014	
(in thousands)	Carrying Value	Fair Value	Carrying Value	Fair Value
Mortgage loans on land & buildings	4,386	4,635	5,319	5,581

NOTE 5: PROPERTY AND EQUIPMENT

Property and Equipment are carried at cost. Depreciation is recorded using the straight-line method over the estimated useful lives of the assets. Improvements to leased premises are amortized using the straight-line method over the shorter of the initial term of the lease or the useful life of the improvement. Leasehold improvements added late in the lease term are amortized over the shorter of the remaining term of the lease (including the upcoming renewal option, if the renewal is reasonably assured) or the useful life of the improvement. Assets under capital leases are amortized in accordance with the Company’s normal depreciation policy for owned assets or over the lease term (regardless of renewal options), if shorter, and the charge to earnings is included in depreciation expense in the consolidated financial statements. Gains or losses on the sale of assets are recorded as a component of selling, general and administrative expenses.

The following illustrates the breakdown of the major categories within Property and Equipment (in thousands):

	May 3, 2014	February 1, 2014
Property and equipment, at cost:		
Buildings and building improvements	$ 115,357	$ 114,688
Leasehold improvements	78,926	78,101
Automobiles and vehicles	5,621	5,459
Airplane	4,697	4,697
Furniture, fixtures and equipment	269,757	268,771
	474,358	471,716
Less: Accumulated depreciation and amortization	(335,170)	(328,686)

	139,188	143,030
Construction in progress	3,259	1,729
Land	8,604	8,604
Total Property and equipment, at depreciated cost	$ 151,051	$ 153,363

NOTE 6: EXIT AND DISPOSAL ACTIVITIES

Lease Termination

A lease obligation still exists 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 the first three months of fiscal 2014, we utilized and added less than $0.1 million of the remaining lease liability for the fiscal 2008 store closures, leaving $0.1 million in the reserve at May 3, 2014.

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

	Balance at February 1, 2014	Additions	Utilization	Ending Balance May 3, 2014
Lease contract termination liability	$ 0.1	$ -	$ -	$ 0.1

NOTE 7: ACCUMULATED OTHER COMPREHENSIVE INCOME

Comprehensive income consists of two components, net income and other comprehensive income (loss). Other comprehensive income (loss) refers to gains and losses that under GAAP are recorded as an element of shareholders' equity but are excluded from net income. The Company's accumulated other comprehensive income includes the unrecognized prior service costs, transition obligations and actuarial gains/losses associated with our postretirement benefit plan.

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

(in thousands)	Thirteen Weeks Ended May 3, 2014	Thirteen Weeks Ended May 4, 2013	Year Ended February 1, 2014
Accumulated other comprehensive income	$ 703	$ 794	$ 794
Amortization of postretirement benefit	-	-	(91)
Ending balance	$ 703	$ 794	$ 703

NOTE 8: RELATED PARTY TRANSACTIONS

Atlantic Retail Investors, LLC, which is partially owned by Michael J. Hayes, a director of the Company and Chairman of the Board, owns the land and buildings occupied by three Fred's stores. The terms and conditions regarding the leases on these locations are consistent in all material respects with other stores leases of the Company with unrelated landlords. The total rental payments related to related party leases were $75.2 thousand for both of the thirteen weeks ended May 3, 2014 and May 4, 2013.

NOTE 9: LEGAL CONTINGENCIES

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. On or about March 15, 2013, the Magistrate Judge issued a Report and Recommendation that the case be conditionally certified as a collective action, which the District Court Judge affirmed. As a result, notice of a collective action was sent to the appropriate class as required by the Court. Approximately 194 plaintiffs have opted into the suit. The Company believes that all of its assistant managers have been properly paid and that the matter is not appropriate for collective action treatment. The Company is and will continue to vigorously defend this matter; however, it is not possible to predict whether Chapman will ultimately be able to proceed collectively and no assurances can be given that the Company will be successful in the defense of the action on the merits or otherwise. In accordance with FASB ASC 450, "Contingencies", the Company does not believe at this time that a loss in this matter is probable. For these reasons, the Company is unable to estimate any potential loss or range of loss in the matter. The Company has tendered the matter to its Employment Practices Liability Insurance ("EPLI") carrier for coverage under its EPLI policy. At this time, the Company expects that the EPLI carrier will participate in the defense or resolution of part or all of the potential claims.

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 these proceedings and claims should not have a material adverse effect on the financial statements as a whole. However, litigation involves an element of uncertainty. Future developments could cause these actions or claims, individually or in aggregate, to have a material adverse effect on the financial statements as a whole.

NOTE 10: CUMULATIVE EFFECT OF A CORRECTION OF AN ERROR IN THE CASH FLOW STATEMENT

In the second quarter of 2013, the Condensed Consolidated Statements of Cash Flows (Cash Flows Statement) was changed to correct the presentation of proceeds received and net gain resulting from the sale of pharmacy department prescription files. From time-to-time, the Company closes an underperforming pharmacy department and sells the related prescription files. In previous filings, the proceeds received and gain resulting from the sale of pharmacy department prescription files were neither presented on the face of the Cash Flows Statement as an addition to cash flows provided by investing activities nor as a reduction to cash flows provided by operating activities. Going forward, the proceeds received from the sale of pharmacy prescription files will be shown on the face of the Cash Flows Statement as part of proceeds from asset dispositions in investing activities, and the net gain from the sale will be presented as a part of net loss (gain) on asset disposition in operating activities.

In accordance with Staff Accounting Bulletin 99, quantifying the impact of the corrected presentation on our Cash Flows Statement, we have determined that the quantitative impact on the Cash Flows Statement was immaterial to both the net cash provided by operating activities and the net cash used by investing activities. In addition, qualitatively, this misstatement had no effect on the Consolidated Income Statements or Consolidated Balance Sheets presented in our filed Form 10-Qs or Form 10-Ks from fiscal year 2011 through the first quarter of 2013. Additionally, there was no impact on our debt covenant requirements or our previous Liquidity and Capital Resources disclosures.

Item 2:

Management's Discussion and Analysis of Financial

Condition and Results of Operations

GENERAL

Executive Overview

Fred's, Inc. and its subsidiaries ("We", "Our", "Us" or "Company") operates, as of May 3, 2014, 704 retail stores, including 21 franchised Fred's stores, in 15 states in the southeastern United States. We currently offer 359 full service pharmacies located within our stores. Our mission is to be the hometown pharmacy and discount store that provides a fast, fun and friendly low-price place to shop. Approximately 84% of our stores are located in markets with populations of 15,000 or less, where Fred's provides often the only, or one of only two, pharmacies in town.

Fred's is a unique combination of pharmacy, dollar store and mass merchant. We offer a broader assortment than traditional dollar stores and pharmacies with greater convenience than big box retailers. We offer different product categories to drive shopping frequency (including consumables such as tobacco, food and beverage, prescription pharmaceuticals, paper and cleaning supplies, pet supplies, health and beauty aids) and to drive higher profitability (including discretionary products such as home décor, seasonal merchandise, auto and hardware and lawn and garden). Our general merchandise selection includes a diverse array of brand name and private label staple and discretionary products at value prices. We operate in the discount retail variety sector and approximately 90% of the products offered in our stores retail between $1 and $10.

Fred's caters to value-oriented, budget-conscious, primarily female shoppers who prefer convenience over the hassles of big-box shopping. Similar to the other retailers in this sector, our customers have continued to be negatively impacted by the pressures of the current macroeconomic environment. Those primary pressures include employment challenges, the rising costs of food, gasoline and energy, increasing payroll taxes and the uncertainty of medical expenses just as the deadline to sign up for the Affordable Care Act ended on March 31, 2014. While some of these key factors have shown signs of improvement, the uncertainty about the length of time it will take for the economy to recover and the strength of that recovery has left consumers wary and understandably conservative. As a percent of total sales, spending in our discretionary merchandise categories, which we classify as Household Goods and Apparel and Linens, declined to 26.8% of net sales at the end of the first quarter of 2014 as compared to 29.2% at the end of the first quarter of 2013.

In the first quarter of 2013, the Company announced the launch of our three-year reconfiguration plan to regain the momentum we had in the prior three years in driving toward our 4% operating margin goal. In 2009, 2010 and 2011 our operating income as a percent of sales was 2.1%, 2.5% and 2.7%, respectively. The main focus of our reconfiguration plan is to improve our overall store productivity and space efficiency while enhancing the product selection in stores with pharmacies. The plan has two fundamental principles: to aggressively accelerate our pharmacy department presence and to improve our general merchandise space efficiency and productivity.

Fred’s stores with pharmacy departments have an operating margin of 4.5% to 5.0%, which exceeds our 4.0% operating margin goal. Our pharmacy department is a key differentiating factor from other small-box discount retailers. Pharmacy department penetration was 50% at the end of 2012 and 52% at the end of 2013. Under the reconfiguration plan, we are increasing pharmacy department penetration to 65% to 70% by the end of 2015. To achieve this goal, we will concentrate on adding pharmacies to existing stores without pharmacy departments, open all new stores with a pharmacy department and make opportunistic acquisitions that will operate as Xpress pharmacy locations until they become a future full-service location. Our pharmacy departments should continue to benefit from the aging U.S. population, an expected increase in patient prescription compliance and newly insured customers under the Affordable Care Act.

This growth in pharmacy department locations positions us to expand our other pharmacy offerings such as our specialty pharmacy program, our customer-centric clinical services offerings and an improved over-the-counter offering in health and beauty aids. Specialty pharmacy is the fastest-growing segment of the pharmacy industry. During 2012, we entered into an agreement with Diplomat Specialty Pharmacy to provide clinical and patient administration services necessary to manage our patients who are receiving specialty medications. Specialty medications are high cost drugs that are used to treat chronic or rare conditions such as hepatitis, cancer, multiple sclerosis, rheumatoid arthritis and other complex diseases. We are pleased with the initial progress surrounding the execution of our specialty pharmacy initiative, including the on-going relationship with Diplomat Specialty Pharmacy and the launch of our internal specialty pharmacy facility, EIRIS Health Services, which opened late in the third quarter of 2013. Fred’s clinical services offerings are focused on driving increased immunizations, assisting our customers with medication therapy management, rolling out “Time My Meds”, which is focused on prescription adherence, and expanding our disease management services, beginning with diabetes management.

Towards our efforts to aggressively accelerate our pharmacy department penetration, we added 24 new pharmacy departments in fiscal 2013 consisting of sixteen acquisitions and eight cold starts, and seven new pharmacy departments in the first quarter of 2014, consisting of five acquisitions and two cold starts, totaling 31 new pharmacies since the launch of the reconfiguration plan. We also had the opportunity to sell the prescription files and close fourteen underperforming pharmacies and convert four Xpress locations into full-service stores. These efforts brought the pharmacy department total to 359, up 3.8% from 2012. As a percent of our company-owned store locations, pharmacy department penetration increased from 50% at year end 2012 to 53% at the end of the first quarter of 2014. As a percent of total sales, pharmacy department sales increased to 40.0% of sales in the first quarter of 2014 as compared to 35.7% in the first quarter of 2013. Pharmacy department additions for 2014 are planned in the range of 30 to 40, with closings of approximately 3 pharmacy departments. Pharmacy department penetration by the end of fiscal 2014 will be approximately 56%.

Improving our general merchandise space efficiency and productivity is centered on expanding space in our discretionary product lines. The three main areas of focus of our reconfiguration plan are (1) the expansion of our Hometown Auto and Hardware program, (2) expansion of seasonal space and (3) expansion of health and beauty aids in stores with pharmacy departments.

We began testing our reconfiguration plan in the third quarter of 2012 by reallocating space in 78 stores to deploy our expanded Hometown Auto and Hardware program. As of May 3, 2014, 370 stores, or 54% of our retail stores, have been reset with the expanded Hometown Auto and Hardware program. By the end of the first quarter of 2014, approximately 50% of these stores have anniversaried their reset and continue to perform well, delivering comparable store sales increases of 6% to 11%, respectively, and outperforming on total comparable store sales above the remainder of the chain. By the end of the second quarter of 2014, approximately 374 stores, or 55% of our retail stores will be reconfigured with the expanded hardware and auto format.

As part of our plan, we are committed to reconfiguring 12% to 15% of our selling square feet from less productive categories on a sales-per-square foot and gross margin-per square foot basis to more productive categories. The goal of these changes is to shift our general merchandise business to a healthier balance between higher gross margin discretionary product lines and lower margin consumable products lines while accelerating our pharmacy department and healthcare services offerings. We believe these efforts can improve overall store productivity and space efficiency and enhance product selection in stores with pharmacies. To those efforts, the Company announced, in our press release filed Thursday, March 28, 2014, that we will exit three primary categories in 2014: footwear, select indoor furniture and electronics, primarily televisions. As a result, we recorded an inventory markdown reserve of $1.7 million or $0.03 per diluted share in the fourth quarter of 2013.

In our press release filed Thursday, May 29, 2014, the Company announced updates to our reconfiguration plan in fiscal 2014. We have learned through extensive research that customers use Fred’s for their "need it now" convenience trips. We see this as an opportunity to further leverage non-consumable, higher margin "immediate need" convenience departments which include Bed, Bath, Kitchen, Home Improvement (which includes Hardware), Seasonal and Pet. Our plan is to gain greater top of mind awareness with our existing customers that we have these products and categories available to them.

Beginning in the second quarter, we will implement marketing and branding changes to emphasize those “need it now” trips and drive customer traffic. We will begin relaying our stores with a new front-end configuration for a faster checkout and a realignment of category adjacencies to highlight and brand our in-store convenience centers. The front end of our stores will be re-laid with power displays and pallets, along with a faster check-out configuration, all focused on ease of shopping and designed to become the convenient, small-box store of choice.

First Quarter 2014 Financial Results

As reported in our earnings release published on May 29, 2014, sales in the first quarter of 2014 decreased 0.6% to $498.3 million from $501.5 million in the first quarter of 2013. Comparable store sales for the quarter declined 1.9% as compared to a decline of 1.3% in the same quarter last year. During the first quarter, sales were heavily impacted by poor weather, which affected comparable store sales by approximately 200 basis points. As a percent of sales, pharmacy department sales increased to 40.0% in 2014, the highest percent of sales in the Company’s history, from 36.1% in 2013.

Gross margin as a percent of net sales for the first quarter of 2014 declined 150 basis points to 28.6% from 30.1%. Gross margin was negatively impacted by the extraordinary inflation in pharmacy department purchases, primarily generic pharmaceuticals, coupled with pressure on reimbursement rates. The general merchandise departments were impacted by the ongoing sales mix shift from discretionary to consumables as well as increased promotional activities. We expect the increasing rate of pharmaceutical inflation will continue to have a negative impact on earnings in the second quarter of 2014.

Earnings per diluted share for the first quarter of 2014 were $0.17 as compared to $0.31 in same quarter of the prior year. The expiration of the Work Opportunity Tax Credits on December 31, 2013 negatively impacted earnings per diluted share by $0.01. It is anticipated that Congress will approve an extension of these credits later in 2014 with retroactive application.

At May 3, 2014, the balance sheet remained strong with cash and cash equivalents at $8.2 million up from $7.8 million at the same time last year. The inventory balance at the end of the first quarter increased 3.5% to $382.9 million from $369.9 million at the same time last year. The increase was driven by the accelerated pharmacy department growth in line with our reconfiguration plan as well as inflation experienced in the pharmacy department. At the end of the first quarter of 2014, there were no borrowings under our revolving line of credit and total indebtedness was comprised of mortgage liabilities and totaled $4.3 million as compared to $5.8 million at the end of the first quarter of 2013.

In our sales release dated January 9, 2014, the Company announced that we have engaged financial advisors Bank of America Merrill Lynch and Peter J. Solomon to review strategic opportunities to enhance shareholder value. The Board of Directors, with the assistance of its financial advisors, will consider a range of options, which may include a sale or merger of the Company, a strategic alliance with another company, a recapitalization of the Company or none of the foregoing. No decision has been made to enter into a transaction at this time, and there can be no assurance that we will enter into a transaction in the future. The Company does not intend to comment further regarding this process until such time as its Board of Directors has determined the outcome of the process or otherwise determined that disclosure is required or appropriate.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The Company’s discussion and analysis of its financial condition and results of operations are based upon the Company’s condensed financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The critical accounting matters that are particularly important to the portrayal of the Company’s financial condition and results of operations, and require some of management’s most difficult, subjective and complex judgments, are described in detail in the Company’s Annual Report on Form 10-K for the fiscal year ended February 1, 2014. The preparation of condensed financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, the Company evaluates its estimates, including those related to inventories, income taxes, insurance reserves, contingencies and litigation. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

RESULTS OF OPERATIONS

<u>Thirteen Weeks Ended May 3, 2014 and May 4, 2013</u>

Sales

Net sales for the first quarter of 2014 decreased to $498.3 million from $501.5 million in 2013, a year-over-year decrease of $3.2 million or 0.6%. On a comparable store basis, sales decreased 1.9% compared with a 1.3% decrease in the same period last year.

General merchandise (non-pharmacy) sales decreased 7.0% to $290.4 million from $312.3 million in 2013. We experienced sales decreases in departments such as beverages, electronics, food, bed and window and cleaning supplies which were partially offset by sales increases in tobacco, ladies apparel and accessories, and hardware.

The Company's pharmacy department sales were 40.0% of total sales ($199.4 million) in 2014 compared to 36.1% of total sales ($180.8 million) in the prior year and continue to rank as the largest department within the Company. The total sales in this department increased 10.3% over 2013 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 EIRIS Specialty Pharmacy and pharmacy departments in existing store locations.

During the quarter, there were no changes to the franchised locations, with 21 franchised locations at May 3, 2014 and May 4, 2013. Sales to our franchised locations during 2014 were $8.4 million (1.7% of sales) unchanged from the same quarter last year. The Company does not intend to expand its franchise network.

The following table illustrates the sales mix, unadjusted for deferred layaway sales:

	Thirteen Weeks Ended			
	May 3, 2014		May 4, 2013	
Pharmaceuticals	39.7	%	35.7	%
Household Goods	21.3	%	22.7	%
Food and Tobacco	17.0	%	17.6	%
Paper and Cleaning Supplies	7.9	%	8.4	%
Health and Beauty Aids	6.9	%	7.4	%
Apparel and Linens	5.5	%	6.5	%
Franchise	1.7	%	1.7	%
	100.0	%	100.0	%

For the quarter, comparable store customer traffic decreased 4.3% over last year while the average customer ticket increased 2.4% to $22.07.

Gross Profit

Gross profit for the first quarter decreased to $142.5 million in 2014 from $151.0 million in 2013, a decrease of $8.5 million or 5.7%. Gross margin, measured as a percentage of sales, was 28.6% in 2014, a decrease of 150 basis points as compared to 30.1% in the same quarter last year. In the quarter, gross margin deleveraging was driven by extraordinary generic pharmaceutical inflation coupled with continued pressure on generic pharmaceutical reimbursement rates. The reimbursement adjustments from third parties have not been made at the speed of the manufacturer’s rate of price increases. Also contributing to the gross margin deleveraging is the general merchandise sales mix shift toward lower margin consumable goods and aggressive promotional activities.

Selling, General and Administrative Expenses

Selling, general and administrative expenses, including depreciation and amortization, decreased to $132.4 million in 2014 from $133.2 million in 2013, a decrease of $0.8 million. As a percentage of sales, selling, general and administrative expenses, including depreciation and amortization remained flat at 26.6% for both 2014 and 2013. For the quarter, an increase in occupancy related costs (55 basis points) was offset by a reduction in insurance expense (32 basis points) and a favorable experience in the gain or loss recorded on the disposal of fixed assets (20 basis points).

Operating Income

Operating income decreased to $10.0 million in 2014 (2.0% of sales) from $17.8 million in 2013 (3.5% of sales). The $7.8 million decrease in operating income is attributable to the $8.5 million decrease in gross profit, driven by extraordinary generic pharmaceutical inflation coupled with continued pressure on generic pharmaceutical reimbursement rates, the general merchandise sales mix shift and aggressive promotional activities. The decrease to operating income was partially offset by the $0.8 million decrease in selling, general and administrative expenses as detailed in the Selling, General and Administrative Expenses section above.

Interest Expense, Net

Net interest expense for the first quarter totaled $0.1 million or less than 0.1% of sales, unchanged from the first quarter of 2013.

Income Taxes

The effective income tax rate was 38.2% in 2014 compared to 35.3% in 2013. The increase in the effective income tax rate is primarily the result of the expiration of the federal Work Opportunity Tax Credits (WOTC) at the end of 2013. The federal WOTC are expected to be reinstated in a future quarter in 2014.

Net Income

Net income for the first quarter totaled $6.1 million ($0.17 per diluted share) in 2014 as compared to $11.4 million ($0.31 per diluted share) in 2013, a decrease of $5.3 million. The decrease in net income was due to the $8.5 million decrease in gross profit, driven by extraordinary generic pharmaceutical inflation coupled with continued pressure on generic pharmaceutical reimbursement rates. Also decreasing gross profit were the general merchandise sales mix shift toward lower margin consumable goods and aggressive promotional activities. The decrease in gross profit was partially offset by a decrease in income tax expense of $2.5 million driven by lower sales which more than offset the higher effective tax rate and the $0.8 million decrease in selling, general and administrative expenses as detailed in the Selling, General and Administrative Expenses section above.

LIQUIDITY AND CAPITAL RESOURCES

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

Net cash flow provided by operating activities totaled $16.9 million during the thirteen week period ended May 3, 2014 compared to $17.6 million in the same period of the prior year. Cash generated from operating activities primarily resulted from $6.1 million in year-to-date net income, an increase in operating liabilities of $23.7 million and $9.8 million in depreciation and amortization expense, driven by pharmacy department growth. Offsetting the increases to cash were an inventory increase of $21.4 million, attributed to pharmacy department inflation and growth, and a deferred income tax benefit of $1.6 million.

Net cash used in investing activities totaled $12.8 million during the thirteen week period ended May 3, 2014 compared to $8.5 million in the same period last year. Capital expenditures in the first quarter of 2014 totaled $5.2 million related to existing store and pharmacy expenditures ($3.4 million), technology and other corporate expenditures ($1.0 million) and new store and pharmacy expenditures ($0.8 million). In addition, the Company planned expenditures of approximately $30.0 million in 2014 for the acquisition of prescription lists and other pharmacy related items of which $8.4 million has been spent to date. During the first three months of 2014, we opened two full-service stores and four Xpress pharmacy stores. Fred's also closed four full-service stores and two Xpress pharmacy locations during this period. In 2014, the Company is planning capital expenditures, excluding the acquisition of prescription lists, of approximately $29.1 million. Expenditures are planned totaling $21.2 million for new and existing stores and pharmacies. Planned expenditures also include approximately $5.0 million for technology upgrades and approximately $2.9 million for distribution center equipment and other capital maintenance. Technology upgrades in 2014 will be made in the areas of IT software and hardware and mainframe upgrades. To date, the Company has spent $0.7 million towards these improvements.

Net cash used by financing activities totaled $2.6 million during the thirteen week period ended May 3, 2014 compared to $9.4 million in the same period last year. During the first quarter of 2014, we borrowed and re-paid $147.0 million on our revolving line of credit, paid cash dividends of $2.2 million and paid $0.9 million on our mortgage debt. There were $4.4 million in borrowings outstanding at May 3, 2014 related to real estate mortgages compared to $5.3 million at February 1, 2014. There were no borrowings under the revolving line of credit at May 3, 2014.

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

FORWARD-LOOKING STATEMENTS

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

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

- Economic and weather conditions which affect buying patterns of our customers and supply chain efficiency;
- Changes in consumer spending and our ability to anticipate buying patterns and implement appropriate inventory strategies;
- Continued availability of capital and financing;
- Competitive factors, and the ability to recruit and retain employees;
- Changes in the merchandise supply chain;
- Changes in pharmaceutical inventory costs;
- Changes in reimbursement practices for pharmaceuticals;
- Governmental regulation;
- Increases in insurance costs;
- Cyber security risks;
- Increases in fuel and utility rates;

17

- Potential adverse results in the litigation described under Legal Proceedings (see Note 9 - Legal Contingencies);
- Other factors affecting business beyond our control, including (but not limited to) those discussed under Part 1, ITEM 1A "Risk Factors" of the Company's Annual Report on Form 10-K for the fiscal year ended February 1, 2014.

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

Item 3.

QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

We have no holdings of derivative financial or commodity instruments as of May 3, 2014. We are exposed to financial market risks, including changes in interest rates. We had no borrowings under our Revolving Loan and Credit Agreement, which bears interest at our option, on a sliding scale from 1.00% - 1.625% plus LIBOR, or an alternative base rate. An increase in interest rates of 100 basis points would not significantly affect our income. All of our business is transacted in U.S. dollars and, accordingly, foreign exchange rate fluctuations have not had a significant impact on us, and they are not expected to in the foreseeable future.

Item 4.

CONTROLS AND PROCEDURES

(a) Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures. As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) under the Securities and Exchange Act of 1934, as amended (the "Exchange Act")). Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Additionally, they concluded that our disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in the reports that the Company is required to file or submit under the Exchange Act is accumulated and communicated to management, including the Chief Executive Officer and the Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosures.

(b) Changes in Internal Control over Financial Reporting. There have been no changes during the quarter ended May 3, 2014 in the Company's internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In July 2008, a lawsuit styled Jessica Chapman, on behalf of herself and others similarly situated, v. Fred's Stores of Tennessee, Inc. was filed in the United States District Court for the Northern District of Alabama, Southern Division, in which the plaintiff alleges that she and other female assistant store managers are paid less than comparable males and seeks compensable damages, liquidated damages, attorney fees and court costs. The plaintiff filed a motion seeking collective action. On or about March 15, 2013, the Magistrate Judge issued a Report and Recommendation that the case be conditionally certified as a collective action, which the District Court Judge affirmed. As a result, notice of a collective action was sent to the appropriate class as required by the Court. Approximately 194 plaintiffs have opted into the suit. The Company believes that all of its assistant managers have been properly paid and that the matter is not appropriate for collective action treatment. The Company is and will continue to vigorously defend this matter; however, it is not possible to predict whether Chapman will ultimately be able to proceed collectively and no assurances can be given that the Company will be successful in the defense of the action on the merits or otherwise. In accordance with FASB ASC 450, "Contingencies", the Company does not believe that a loss in this matter is probable at this time. For these reasons, the Company is unable to estimate any potential loss or range of loss in the matter. The Company has tendered the matter to its Employment Practices Liability Insurance ("EPLI") carrier for coverage under its EPLI policy. At this time, the Company expects that the EPLI carrier will participate in the defense or resolution of part or all of the potential claims.

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 these proceedings and claims should not have a material adverse effect on the financial statements as a whole. However, litigation involves an element of uncertainty. Future developments could cause these actions or claims, individually or in aggregate, to have a material adverse effect on the financial statements as a whole.

Item 1A. Risk Factors

The risk factors listed in Part I, “Item 1A. Risk Factors” in the Annual Report on Form 10-K for the fiscal year ended February 1, 2014, should be considered with the information provided elsewhere in this Quarterly Report on Form 10-Q, which could materially adversely affect the business, financial condition or results of operations. There have been no material changes to the risk factors as previously disclosed in such Annual Report on Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

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 the open market or through privately negotiated transactions at such times and at such prices as determined to be in the Company’s best interest. 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. These repurchases may be commenced or suspended without prior notice depending on then-existing business or market conditions and other factors. No repurchases were made in the first quarter of 2014, leaving 3.0 million shares available for repurchase at May 3, 2014.

Item 6. Exhibits

Exhibits	
31.1	Certification of Chief Executive Officer.
31.2	Certification of Chief Financial Officer.
32	Certification of Chief Executive Officer and Chief Financial Officer pursuant to rule 13a–14(b) under the Securities Exchange Act of 1934 and 18 U.S.C. Section 1350.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase

101.DEF XBRL Taxonomy Extension Definition Linkbase
101.LAB XBRL Taxonomy Extension Label Linkbase
101.PRE XBRL Taxonomy Extension Presentation Linkbase

19

SIGNATURES

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

	FRED'S, INC.
Date: June 12, 2014	/s/ Bruce A. Efird Bruce A. Efird Chief Executive Officer and President
Date: June 12, 2014	/s/ Jerry A. Shore Jerry A. Shore Executive Vice President, Chief Financial Officer and Chief Operating Officer