

CATO CORP
Form 10-Q
September 10, 2008

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q**

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

For the quarterly period ended August 2, 2008

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 1-31340
THE CATO CORPORATION**

(Exact name of registrant as specified in its charter)

Delaware

56-0484485

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

8100 Denmark Road, Charlotte, North Carolina 28273-5975

(Address of principal executive offices)

(Zip Code)

(704) 554-8510

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of August 19, 2008, there were 27,821,126 shares of Class A common stock and 1,743,525 shares of Class B common stock outstanding.

THE CATO CORPORATION
FORM 10-Q
Quarter Ended August 2, 2008
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THE CATO CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND
COMPREHENSIVE INCOME

	Three Months Ended		Six Months Ended	
	August 2,	August 4,	August 2,	August 4,
	2008	2007	2008	2007
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)
	(Dollars in thousands, except per share data)			
REVENUES				
Retail sales	\$ 230,957	\$ 218,973	\$ 456,748	\$ 443,107
Other income (principally finance charges, late fees and layaway charges)	2,911	2,961	5,948	6,056
Total revenues	233,868	221,934	462,696	449,163
COSTS AND EXPENSES, NET				
Cost of goods sold (exclusive of depreciation shown below)	148,020	147,514	289,640	290,936
Selling, general and administrative (exclusive of depreciation shown below)	63,580	52,463	119,896	103,599
Depreciation	5,657	5,623	11,267	11,014
Interest and other income	(1,709)	(2,316)	(3,609)	(4,209)
	215,548	203,284	417,194	401,340
Income before income taxes	18,320	18,650	45,502	47,823
Income tax expense	6,229	6,140	16,558	16,642
Net Income	\$ 12,091	\$ 12,510	\$ 28,944	\$ 31,181
Basic earnings per share	\$ 0.42	\$ 0.39	\$ 0.99	\$ 0.99
Basic weighted average shares	29,113,017	31,897,365	29,104,465	31,624,979
Diluted earnings per share	\$ 0.41	\$ 0.39	\$ 0.99	\$ 0.97
Diluted weighted average shares	29,200,726	32,189,903	29,180,499	32,040,169

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Dividends per share	\$	0.165	\$	0.165	\$	0.33	\$	0.315
Comprehensive income:								
Net income	\$	12,091	\$	12,510	\$	28,944	\$	31,181
Unrealized gains (losses) on available-for-sale securities, net of deferred income tax expense		(84)		(49)		(320)		(21)
Net comprehensive income	\$	12,007	\$	12,461	\$	28,624	\$	31,160

See notes to condensed consolidated financial statements.

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THE CATO CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS

	August 2, 2008 (Unaudited)	August 4, 2007 (Unaudited)	February 2, 2008
	(Dollars in thousands)		
ASSETS			
Current Assets:			
Cash and cash equivalents	\$ 45,371	\$ 19,929	\$ 21,583
Short-term investments	107,952	150,387	92,995
Accounts receivable, net of allowance for doubtful accounts of \$3,195, \$3,226 and \$3,263 at August 2, 2008, August 4, 2007 and February 2, 2008, respectively	44,026	45,533	45,282
Merchandise inventories	96,864	99,236	118,679
Deferred income taxes	6,904	7,522	6,756
Prepaid expenses	7,880	7,197	7,755
Total Current Assets	308,997	329,804	293,050
Property and equipment net	119,952	126,573	123,190
Other assets	4,482	4,279	4,552
Total Assets	\$ 433,431	\$ 460,656	\$ 420,792
LIABILITIES AND STOCKHOLDERS EQUITY			
Current Liabilities:			
Accounts payable	\$ 83,899	\$ 82,879	\$ 110,848
Accrued expenses	34,052	29,438	27,617
Accrued bonus and benefits	6,830	1,426	2,543
Accrued income taxes	18,433	6,437	7,928
Total Current Liabilities	143,214	120,180	148,936
Deferred income taxes	1,707	8,817	1,707
Other noncurrent liabilities (primarily deferred rent)	20,758	23,286	22,779
Commitments and contingencies:			
Stockholders Equity:			
Preferred stock, \$100 par value per share, 100,000 shares authorized, none issued			
Class A common stock, \$.033 par value per share, 50,000,000 shares authorized; issued 36,281,440 shares, 36,089,761 shares, and 36,109,263 shares at August 2, 2008, August 4, 2007 and February 2, 2008, respectively	1,209	1,203	1,204
Convertible Class B common stock, \$.033 par value per share, 15,000,000 shares authorized; issued 1,743,525 shares, 1,743,525 shares and 1,743,525 shares at August 2, 2008, August 4, 2007 and February 2, 2008, respectively	58	58	58
Additional paid-in capital	60,147	56,913	58,685

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Retained earnings	359,323	349,276	340,088
Accumulated other comprehensive income	389	204	709
	421,126	407,654	400,744
Less Class A common stock in treasury, at cost (8,461,615 shares, 5,299,500 shares and 8,461,615 shares at August 2, 2008, August 4, 2007 and February 2, 2008, respectively)	(153,374)	(99,281)	(153,374)
Total Stockholders' Equity	267,752	308,373	247,370
Total Liabilities and Stockholders' Equity	\$ 433,431	\$ 460,656	\$ 420,792

See notes to condensed consolidated financial statements.

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THE CATO CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended	
	August	August 4,
	2,	2007
	2008	2007
	(Unaudited)	(Unaudited)
	(Dollars in thousands)	
OPERATING ACTIVITIES		
Net income	\$ 28,944	\$ 31,181
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	11,267	11,014
Provision for doubtful accounts	1,462	1,134
Share-based compensation	1,064	812
Excess tax benefits from share-based compensation	(41)	(5,450)
Deferred income taxes		
Loss on disposal of property and equipment	2,510	326
Changes in operating assets and liabilities which provided (used) cash:		
Accounts receivable	(206)	(709)
Merchandise inventories	21,815	16,682
Prepaid and other assets	(55)	(541)
Accrued income taxes	10,546	6,528
Accounts payable, accrued expenses and other liabilities	(18,246)	(3,346)
Net cash provided by operating activities	59,060	57,631
INVESTING ACTIVITIES		
Expenditures for property and equipment	(10,540)	(9,568)
Purchases of short-term investments	(99,820)	(206,024)
Sales of short-term investments	84,395	154,310
Net cash provided by (used in) investing activities	(25,965)	(61,282)
FINANCING ACTIVITIES		
Change in cash overdrafts included in accounts payable		(500)
Dividends paid	(9,710)	(9,961)
Purchase of treasury stock		(4,468)
Proceeds from employee stock purchase plan	233	233
Excess tax benefits from share-based compensation	41	5,450
Proceeds from stock options exercised	129	7,993
Net cash used in financing activities	(9,307)	(1,253)

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Net increase (decrease) in cash and cash equivalents	23,788	(4,904)
Cash and cash equivalents at beginning of period	21,583	24,833
Cash and cash equivalents at end of period	\$ 45,371	\$ 19,929

See notes to condensed consolidated financial statements.

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**THE CATO CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
FOR THE THREE MONTHS AND SIX MONTHS ENDED AUGUST 2, 2008 AND AUGUST 4, 2007**

NOTE 1 GENERAL:

The condensed consolidated financial statements have been prepared from the accounting records of The Cato Corporation and its wholly-owned subsidiaries (the Company), and all amounts shown as of and for the periods ended August 2, 2008 and August 4, 2007 are unaudited. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All such adjustments are of a normal, recurring nature. The results of the interim period may not be indicative of the results expected for the entire year.

The interim financial statements should be read in conjunction with the consolidated financial statements and notes thereto, included in the Company's Annual Report on Form 10-K for the fiscal year ended February 2, 2008.

The year-end condensed consolidated balance sheet data presented for fiscal year ended February 2, 2008 was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

Cash equivalents consist of highly liquid investments with original maturities of three months or less. Investments with original maturities beyond three months are classified as short-term investments.

Short-term investments are classified as available-for-sale. As they are available for current operations, they are classified in the Condensed Consolidated Balance Sheets as current assets. Available-for-sale securities are carried at estimated fair value, with unrealized gains and temporary losses, net of income taxes, reported as a component of accumulated other comprehensive income. Other than temporary declines in fair value of investments are recorded as a reduction in the cost of the investments in the accompanying Condensed Consolidated Balance Sheets and a reduction of interest and other income in the accompanying Condensed Consolidated Statements of Income and Comprehensive Income. The cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. The amortization of premiums, accretion of discounts and realized gains and losses are included in interest and other income.

Merchandise inventories are stated at the lower of cost (first-in, first-out method) or market as determined by the retail inventory method.

On August 28, 2008, the Board of Directors maintained the quarterly dividend at \$.165 per share or an annualized rate of \$.66 per share.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
FOR THE THREE MONTHS AND SIX MONTHS ENDED AUGUST 2, 2008 AND AUGUST 4, 2007

NOTE 2 EARNINGS PER SHARE:

SFAS No. 128, *Earnings Per Share*, requires dual presentation of basic EPS and diluted EPS on the face of all income statements for all entities with complex capital structures. The Company has presented one basic EPS and one diluted EPS amount for all common shares in the accompanying Condensed Consolidated Statements of Income. While the Company's articles of incorporation provide the right for the Board of Directors to declare dividends on Class A shares without declaration of commensurate dividends on Class B shares, the Company has historically paid the same dividends to both Class A and Class B shareholders and the Board of Directors has resolved to continue this practice. Accordingly, the Company's allocation of income for purposes of EPS computation is the same for Class A and Class B shares and the EPS amounts reported herein are applicable to both Class A and Class B shares. Basic EPS is computed as net income divided by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur from common shares issuable through stock options and the Employee Stock Purchase Plan and the potential vestings of restricted stock computed using the treasury stock method.

	Three Months Ended		Six Months Ended	
	August 2, 2008	August 4, 2007	August 2, 2008	August 4, 2007
Weighted-average shares outstanding	29,113,017	31,897,365	29,104,465	31,624,979
Dilutive effect of:				
Stock options	17,168	234,982	15,956	365,822
Restricted stock	70,541	57,035	60,078	48,674
Employee stock purchase plan		521		694
Weighted-average shares and common stock equivalents outstanding	29,200,726	32,189,903	29,180,499	32,040,169

NOTE 3 SUPPLEMENTAL CASH FLOW INFORMATION:

Income tax payments, net of refunds received, for the six months ended August 2, 2008 and August 4, 2007 were \$6,938,000 and \$10,040,000, respectively.

NOTE 4 FINANCING ARRANGEMENTS:

At August 2, 2008, the Company had an unsecured revolving credit agreement, which provided for borrowings of up to \$35 million. The revolving credit agreement is committed until August 2010. The credit agreement contains various financial covenants and limitations, including the maintenance of specific financial ratios with which the Company was in compliance as of August 2,

Table of Contents**THE CATO CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)****FOR THE THREE MONTHS AND SIX MONTHS ENDED AUGUST 2, 2008 AND AUGUST 4, 2007****NOTE 4 FINANCING ARRANGEMENTS (CONTINUED):**

2008. There were no borrowings outstanding under this credit facility during the first six months ended August 2, 2008 or August 4, 2007, respectively, or the fiscal year ended February 2, 2008. Interest on any borrowings is based on LIBOR, which was 2.46% at August 2, 2008.

At August 2, 2008 and August 4, 2007 the Company had approximately \$4,771,000 and \$6,620,000, respectively, of outstanding irrevocable letters of credit relating to purchase commitments.

NOTE 5 REPORTABLE SEGMENT INFORMATION:

The Company has two reportable segments: retail and credit. The Company operated its women's fashion specialty retail stores in 31 states at August 2, 2008, principally in the southeastern United States. The Company offers its own credit card to its customers and all related credit authorizations, payment processing, and collection efforts are performed by a separate subsidiary of the Company.

The following schedule summarizes certain segment information (in thousands):

Three Months Ended August 2, 2008				Six Months Ended August 2, 2008			
	Retail	Credit	Total		Retail	Credit	Total
Revenues	\$231,401	\$ 2,467	\$233,868	Revenues	\$457,710	\$ 4,986	\$462,696
Depreciation	5,646	11	5,657	Depreciation	11,246	21	11,267
Interest and other income	(1,709)		(1,709)	Interest and other income	(3,609)		(3,609)
Income before taxes	17,309	1,011	18,320	Income before taxes	43,628	1,874	45,502
Total assets	361,874	71,557	433,431	Total assets	361,874	71,557	433,431
Capital expenditures	4,893		4,893	Capital expenditures	10,540		10,540
Three Months Ended August 4, 2007				Six Months Ended August 4, 2007			
	Retail	Credit	Total		Retail	Credit	Total
Revenues	\$219,374	\$ 2,560	\$221,934	Revenues	\$444,005	\$ 5,158	\$449,163
Depreciation	5,597	26	5,623	Depreciation	10,964	50	11,014
Interest and other income	(2,316)		(2,316)	Interest and other income	(4,209)		(4,209)
Income before taxes	17,549	1,101	18,650	Income before taxes	45,567	2,256	47,823
Total assets	393,081	67,575	460,656	Total assets	393,081	67,575	460,656
Capital expenditures	5,532	106	5,638	Capital expenditures	9,449	119	9,568

The Company evaluates performance based on income before taxes. The Company does not allocate certain corporate expenses or income taxes to the credit segment.

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NOTE 5 REPORTABLE SEGMENT INFORMATION (CONTINUED):

The following schedule summarizes the direct expenses of the credit segment which are reflected in selling, general and administrative expenses (in thousands):

	Three Months Ended		Six Months Ended	
	August 2, 2008	August 4, 2007	August 2, 2008	August 4, 2007
Bad debt expense	\$ 696	\$ 676	\$ 1,462	\$ 1,134
Payroll	254	245	507	487
Postage	240	235	513	513
Other expenses	255	277	609	718
Total expenses	\$ 1,445	\$ 1,433	\$ 3,091	\$ 2,852

NOTE 6 STOCK BASED COMPENSATION:

As of August 2, 2008, the Company had three long-term compensation plans pursuant to which stock-based compensation was outstanding or could be granted. The Company's 1987 Non-Qualified Stock Option Plan authorized 5,850,000 shares for the granting of options to officers and key employees. The 1999 Incentive Compensation Plan and 2004 Amended and Restated Incentive Compensation Plan authorized 1,500,000 and 1,350,000 shares, respectively, for the granting of various forms of equity-based awards, including restricted stock and stock options to officers and key employees. The 1999 Plan has expired as to the ability to grant new awards.

The following table presents the number of options and shares of restricted stock initially authorized and available for grant under each of the plans:

	1987 Plan	1999 Plan	2004 Plan	Total
Options and/or restricted stock initially authorized	5,850,000	1,500,000	1,350,000	8,700,000
Options and/or restricted stock available for grant:				
February 2, 2008	12,277		1,006,033	1,018,310
August 2, 2008	12,877		866,488	879,365

Stock option awards outstanding under the Company's current plans were granted at exercise prices which were equal to the market value of the Company's stock on the date of grant, vest over five years and expire no later than ten years after the grant date.

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NOTE 6 STOCK BASED COMPENSATION (CONTINUED):

The following is a summary of the changes in stock options outstanding during the six months ended August 2, 2008:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (a) \$
Options outstanding at February 2, 2008	139,075	\$ 12.41	4.64	\$ 494,087
Granted				
Forfeited or expired	(600)	\$ 8.71		
Exercised	(14,475)	\$ 8.93		
Outstanding at August 2, 2008	124,000	\$ 12.83	4.58	\$ 415,299
Vested and exercisable at August 2, 2008	94,825	\$ 12.16	4.10	\$ 380,727

- (a) The intrinsic value of a stock option is the amount by which the market value of the underlying stock exceeds the exercise price of the option.

No options were granted in fiscal 2007 or in the first half of fiscal 2008.

As of August 2, 2008, there was approximately \$112,000 of total unrecognized compensation cost related to nonvested options, which is expected to be recognized over a remaining weighted-average vesting period of 1.05 years. The total intrinsic value of options exercised during the second quarter and six months ended August 2, 2008 was approximately \$80,000 and \$119,000, respectively.

Effective with the adoption of SFAS No. 123R, *Share Based Payment*, the Company began recognizing share-based compensation expense ratably over the vesting period, net of estimated forfeitures. The Company recognized share-based compensation expense for nonvested options of \$23,000 and \$46,000 for the second quarter and six month period ended August 2, 2008, respectively, compared to \$29,000 and \$60,000 for the second quarter and six month period ending August 4, 2007, respectively. These expenses were classified as a component of selling, general and administrative expenses.

Prior to the adoption of SFAS No. 123R, the Company presented all benefits of tax deductions resulting from the exercise of share-based compensation as operating cash flows in the Statements of Cash Flows. SFAS No. 123R requires the benefits of tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. For the six months ended August 2, 2008 and August 4, 2007, the Company reported \$41,000 and \$5,450,000 of excess tax benefits as a financing cash inflow, respectively, in addition to \$362,000 and \$8,226,000 in cash proceeds received from the exercise of stock options and Employee Stock

Purchase Plan purchases, respectively.

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NOTE 6 STOCK BASED COMPENSATION (CONTINUED):

The Company's Employee Stock Purchase Plan allows eligible full-time employees to purchase a limited number of shares of the Company's Class A Common Stock during each semi-annual offering period at a 15% discount through payroll deductions. During the six months ended August 2, 2008 and August 4, 2007, the Company sold 18,158 and 12,463 shares to employees at an average discount of \$2.15 and \$3.30 per share, respectively, under the Employee Stock Purchase Plan. The compensation expense recognized for the 15% discount given under the Employee Stock Purchase Plan was approximately \$39,000 and \$41,000 for the six months ended August 2, 2008 and August 4, 2007, respectively.

In accordance with SFAS No. 123R, the fair value of current restricted stock awards is estimated on the date of grant based on the market price of the Company's stock and is amortized to compensation expense on a straight-line basis over the related vesting periods. As of August 2, 2008 and August 4, 2007, there was \$6,342,000 and \$5,786,000 of total unrecognized compensation cost related to nonvested restricted stock awards, which have a remaining weighted-average vesting period of 3.45 years and 4.01 years, respectively. The total fair value of the shares recognized as compensation expense during the second quarter and six months ended August 2, 2008 was \$514,000 and \$950,000 compared to \$397,000 and \$698,000 for the second quarter and six months ended August 4, 2007.

The following summary shows the changes in the shares of restricted stock outstanding during the six months ended August 2, 2008:

	Number of Shares	Weighted Average Grant Date Fair Value Per Share
Restricted stock awards at February 2, 2008	301,967	\$ 22.56
Granted	150,795	16.61
Vested		
Forfeited	(11,250)	23.88
Restricted stock awards at August 2, 2008	441,512	\$ 20.50

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THE CATO CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
FOR THE THREE MONTHS AND SIX MONTHS ENDED AUGUST 2, 2008 AND AUGUST 4, 2007

NOTE 7 INCOME TAXES:

For the quarter ended August 2, 2008, the Company's effective tax rate was 34%. During the next 12 months, various taxing authorities' statutes of limitations will expire which could result in a potential reduction of unrecognized tax benefits. In addition, certain federal and state examinations may close, the ultimate resolution of which could materially affect the effective tax rate.

NOTE 8 FAIR VALUE MEASUREMENTS:

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. Applicable provisions of SFAS 157 were adopted by the Company effective February 3, 2008. In February 2008, the FASB issued FASB Staff Position 157-2, *Effective date of FASB Statement No. 157*, which delayed for one year the effective date SFAS 157 for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis. The Company has not yet determined the impact on its financial statements of the February 1, 2009 adoption of SFAS No. 157-2 as it pertains to non-financial assets and liabilities.

The following table sets forth information regarding the Company's financial assets that are measured at fair value (in thousands).

Description	Fair Value Measurements at Reporting Date Using			
	August 2, 2008	Quoted Market Prices in Active Market for Identical Assets/Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Short term investments	\$ 107,952	\$ 103,552	\$4,400	
Other Assets	2,700	501	2,199	

The Company's investment portfolio was primarily invested in tax exempt auction rate securities and governmental debt securities held in managed funds. These securities are classified as available-for-sale as they are highly liquid and are recorded on the balance sheet at estimated fair value, with unrealized gains and temporary losses reported net of taxes as accumulated other comprehensive income.

As of August 2, 2008, the Company held \$56.3 million in auction rate securities (ARS) issued by tax exempt municipal authorities and agencies and rated A or better. The underlying securities have contractual maturities which generally range from seven to thirty years. The ARS are recorded at estimated fair value and classified as available for sale due to the expected resetting of the interest rates every 7 to 35 days via the auction process. Of the \$56.3 million in ARS, \$4.4 million failed their last auctions as of August 2, 2008. The Company has experienced continued reductions in its failed ARS and reasonably expects all remaining ARS to either experience successful auctions or be called within a year and so has classified them as short term investments.

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**THE CATO CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
FOR THE THREE MONTHS AND SIX MONTHS ENDED AUGUST 2, 2008 AND AUGUST 4, 2007**

NOTE 8 FAIR VALUE MEASUREMENTS (CONTINUED):

The Company classified these failed ARS securities as Level 2 items under SFAS 157 since they were not trading within ARS auctions and there is not an actively quoted market price for these securities. Additionally, the Company valued these failed ARS investments at par using a number of market based inputs to estimate the fair value including; (i) the underlying credit quality of the issuer and insurer and the probability of default of the issue, (ii) the Company's experience and observations with ARS investments that were similar in many material aspects such as credit quality, yield, coupon or term to the remaining failed securities, (iii) the present value of future principal and interest payments discounted at rates reflecting current market conditions, reflecting the Company's determination that the effects on the ARS's estimated fair value of the increased penalty interest being paid by the non-auctioning bonds, as offset by a liquidity/risk value reduction, would render the fair values materially the same as their carrying value (par), (iv) the timing of expected future cash flows, and (v) the likelihood of repurchase at par for each security.

NOTE 9 RECENT ACCOUNTING PRONOUNCEMENTS:

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value. SFAS 159 applies to all entities that elect the fair value option. SFAS 159 was effective for the Company on February 3, 2008. The adoption of SFAS 159 did not have an impact on the Company's financial position, results of operations or cash flows.

On June 14, 2007, the FASB reached consensus on EITF Issue No. 06-11, *Accounting for Income Tax Benefits of Dividends on Share-Based Payment*. EITF Issue No. 06-11 requires that a realized income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to associates for equity classified nonvested equity shares, nonvested equity share units, and outstanding equity share options should be recognized as an increase to additional paid-in capital. The amount recognized in additional paid-in capital for the realized income tax benefit from dividends on those awards should be included in the pool of excess tax benefits available to absorb tax deficiencies on share-based payment awards. EITF Issue No. 06-11 is effective for fiscal years beginning on or after December 15, 2007. The impact of the Company's adoption of EITF Issue No. 06-11 was immaterial.

In June 2008, the FASB issued FSP No. EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*. EITF 03-6-1 requires that unvested share-based payments that contain nonforfeitable rights to dividends are participating securities and they shall be included in the computation of EPS pursuant to the two class method. EITF 03-6-1 is effective for fiscal years beginning after December 15, 2008. The Company is in the process of evaluating the impact that the adoption of EITF 03-6-1 will have on its financial statements.

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THE CATO CORPORATION

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD LOOKING INFORMATION:

The following information should be read along with the Unaudited Condensed Consolidated Financial Statements, including the accompanying Notes appearing in this report. Any of the following are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended: (1) statements in this Form 10-Q that reflect projections or expectations of our future financial or economic performance; (2) statements that are not historical information; (3) statements of our beliefs, intentions, plans and objectives for future operations, including those contained in Management's Discussion and Analysis of Financial Condition and Results of Operations; (4) statements relating to our operations or activities for fiscal 2008 and beyond, including, but not limited to, statements regarding expected amounts of capital expenditures and store openings, relocations, remodelings and closures; and (5) statements relating to our future contingencies. When possible, we have attempted to identify forward-looking statements by using words such as expects, anticipates, approximates, believes, estimates, hopes, intends, may, plans, should and various other words and similar expressions. We can give no assurance that actual results or events will not differ materially from those expressed or implied in any such forward-looking statements. Forward-looking statements included in this report are based on information available to us as of the filing date of this report, but subject to known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from those contemplated by the forward-looking statements. Such factors include, but are not limited to, the following: general economic conditions; competitive factors and pricing pressures; our ability to predict fashion trends; consumer apparel buying patterns; adverse weather conditions; inventory risks due to shifts in market demand; and other factors discussed under Risk Factors in Part I, Item 1A of our annual report on Form 10-K for the fiscal year ended February 2, 2008 (fiscal 2007), as amended or supplemented, and in other reports we file with or furnish to the SEC from time to time. We do not undertake, and expressly decline, any obligation to update any such forward-looking information contained in this report, whether as a result of new information, future events, or otherwise.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF
OPERATIONS (CONTINUED)****CRITICAL ACCOUNTING POLICIES:**

The Company's accounting policies are more fully described in Note 1 to the consolidated financial statements included in the Company's Annual Report on Form 10-K. As disclosed in Note 1 of Notes to Consolidated Financial Statements, the preparation of the Company's financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions about future events that affect the amounts reported in the financial statements and accompanying notes. Future events and their effects cannot be determined with absolute certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results inevitably will differ from those estimates, and such differences may be material to the financial statements. The most significant accounting estimates inherent in the preparation of the Company's financial statements include the allowance for doubtful accounts receivable, reserves relating to workers' compensation, general and auto insurance liabilities, reserves for group health insurance, reserves for inventory markdowns, calculation of asset impairment, shrinkage accrual and reserves for uncertain tax positions.

The Company's critical accounting policies and estimates are discussed with the Audit Committee.

RESULTS OF OPERATIONS:

The following table sets forth, for the periods indicated, certain items in the Company's unaudited Condensed Consolidated Statements of Income and Comprehensive Income as a percentage of total retail sales:

	Three Months Ended		Six Months Ended	
	August 2, 2008	August 4, 2007	August 2, 2008	August 4, 2007
Total retail sales	100.0%	100.0%	100.0%	100.0%
Total revenues	101.3	101.3	101.3	101.4
Cost of goods sold	64.1	67.4	63.4	65.7
Selling, general and administrative	27.5	23.9	26.2	23.4
Depreciation	2.5	2.6	2.5	2.5
Interest and other income	(0.7)	(1.1)	(0.8)	(1.0)
Income before income taxes	7.9	8.5	10.0	10.8
Net income	5.2	5.7	6.3	7.0

Table of Contents**THE CATO CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF
OPERATIONS (CONTINUED)****RESULTS OF OPERATIONS (CONTINUED):****Comparison of Second Quarter and First Six Months of 2008 with 2007.**

Total retail sales for the second quarter were \$231.0 million compared to last year's second quarter sales of \$219.0 million, a 5% increase. Same-store sales increased 2% in the second quarter of fiscal 2008. For the six months ended August 2, 2008, total retail sales were \$456.7 million compared to last year's first six months sales of \$443.1 million, and same-store sales remained flat for the comparable six month period. Total revenues, comprised of retail sales and other income (principally, finance charges and late fees on customer accounts receivable and layaway fees), were \$233.9 million and \$462.7 million for the second quarter and six months ended August 2, 2008, respectively, compared to \$221.9 million and \$449.2 million for the second quarter and six months ended August 4, 2007, respectively. The Company operated 1,287 stores at August 2, 2008 compared to 1,306 stores at the end of last year's second quarter. For the first six months of 2008 the Company opened 32 stores and closed 63 stores. Credit revenue of \$2.5 million represented 1.1% of total revenues in the second quarter of 2008, compared to 2007 credit revenue of \$2.6 million or 1.2% of total revenues. The slight reduction in credit revenue was due to lower finance charge and late fee income from lower sales under the Company's proprietary credit card, partially offset by improved collections compared to the prior year. Credit revenue is comprised of interest earned on the Company's private label credit card portfolio and related fee income. Related expenses include principally bad debt expense, payroll, postage and other administrative expenses and totaled \$1.4 million in the second quarter of 2008, flat compared to last year's second quarter expenses of \$1.4 million. Bad debt expense was higher compared to the second quarter and first six months of 2007, partially offset by lower administrative expenses.

Other income in total, as included in total revenues was \$2.9 million and \$5.9 million for the second quarter and first six months of fiscal 2008, compared to \$3.0 million and \$6.1 million for the prior year's comparable three and six month period, respectively. The decrease resulted primarily from lower finance charges.

Cost of goods sold was \$148.0 million, or 64.1% of retail sales and \$289.6 million or 63.4% of retail sales for the second quarter and first six months of fiscal 2008, compared to \$147.5 million, or 67.4% of retail sales and \$290.9 million, or 65.7% of retail sales for the prior year's comparable three and six month period, respectively. The overall decrease in cost of goods sold as a percent of retail sales for the second quarter and first six months of 2008 resulted primarily from lower markdowns partially offset by higher occupancy costs. The decrease in markdowns was primarily attributable to tight inventory management and higher sell-throughs of regular priced merchandise. Cost of goods sold includes merchandise costs, net of discounts and allowances, buying costs, distribution costs, occupancy costs, freight and inventory shrinkage. Net merchandise costs and in-bound freight are capitalized as inventory costs.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF
OPERATIONS (CONTINUED)****RESULTS OF OPERATIONS (CONTINUED):**

Buying and distribution costs include payroll, payroll-related costs and operating expenses for the buying departments and distribution center. Occupancy expenses include rent, real estate taxes, insurance, common area maintenance, utilities and maintenance for stores and distribution facilities. Total gross margin dollars (retail sales less cost of goods sold) increased by 15.9% to \$82.9 million and by 9.8% to \$167.1 million for the second quarter and first six months of fiscal 2008, compared to \$71.5 million and \$152.2 million for the prior year's comparable three and six month periods, respectively. Gross margin as presented may not be comparable to those of other entities.

Selling, general and administrative expenses (SG&A) primarily include corporate and store payroll, related payroll taxes and benefits, insurance, supplies, advertising, bank and credit card processing fees and bad debts. SG&A expenses were \$63.6 million, or 27.5% of retail sales and \$119.9 million, or 26.2% of retail sales for the second quarter and first six months of fiscal 2008, compared to \$52.5 million, or 23.9% of retail sales and \$103.6 million, or 23.4% of retail sales for prior year's comparable three and six month period, respectively. SG&A expenses as a percentage of retail sales increased 360 basis points for the second quarter of fiscal 2008 as compared to the prior year and increased 280 basis points for the first six months of fiscal 2008 as compared to the prior year. The increase in SG&A expenses as a percentage of retail sales and the overall dollar increase for the second quarter of fiscal 2008 and the first six months of fiscal 2008 was primarily attributable to an increase in incentive based compensation expenses, the closure of 47 underperforming stores, worker's compensation and group health insurance expenses.

Depreciation expense was \$5.7 million, or 2.5% of retail sales and \$11.3 million or 2.5% of retail sales, for the second quarter and first six months of fiscal 2008, compared to \$5.6 million, or 2.6% of retail sales and \$11.0 million, or 2.5% of retail sales, for prior year's comparable three and six month periods, respectively.

Interest and other income was \$1.7 million, or 0.7% of retail sales and \$3.6 million, or 0.8% of retail sales for the second quarter and first six months of fiscal 2008, compared to \$2.3 million, or 1.1% of retail sales and \$4.2 million, or 1.0% of retail sales, for the prior year's comparable three and six month periods, respectively. The decrease in fiscal 2008 resulted primarily from lower interest rates and lower investment balances.

Income tax expense was \$6.2 million, or 2.7% of retail sales and \$16.6 million, or 3.6% of retail sales, for the second quarter and first six months of fiscal 2008, compared to \$6.1 million, or 2.8% of retail sales and \$16.6 million, or 3.8% of retail sales, for the prior year's comparable three and six month periods. The slight increase for the second quarter resulted from a higher effective tax rate primarily due to lower tax credits. The effective income tax rate for the second quarter of fiscal 2008 was 34.0% compared to 32.9% for the second quarter of 2007. The decrease for the six month period resulted from lower pre-tax income offset by a higher effective tax rate. The effective income tax rate for the first six months of fiscal 2008 was 36.4% compared to 34.8% for the six months of fiscal 2007.

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**THE CATO CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF
OPERATIONS (CONTINUED)**

LIQUIDITY, CAPITAL RESOURCES AND MARKET RISK:

The Company has consistently maintained a strong liquidity position. Cash provided by operating activities during the first six months of fiscal 2008 was \$59.1 million as compared to \$57.6 million in the first six months of fiscal 2007. These amounts enable the Company to fund its regular operating needs, capital expenditure program, cash dividend payments and purchase of treasury stock. In addition, the Company maintains a \$35 million unsecured revolving credit facility for short-term financing of seasonal cash needs. There were no outstanding borrowings on this facility at August 2, 2008.

Cash provided by operating activities for the first six months of fiscal 2008 was primarily generated by earnings adjusted for depreciation and changes in working capital. The increase of \$1.5 million for the first six months of fiscal 2008 as compared to the first six months of fiscal 2007 was primarily due to an increase in inventories, accrued income taxes and excess tax benefits offset by a decrease in accounts payable, accrued expenses and other liabilities and net income in fiscal 2008.

The Company believes that its cash, cash equivalents and short-term investments, together with cash flows from operations and borrowings available under its revolving credit agreement, will be adequate to fund the Company's planned capital expenditures, dividends, share repurchases and other operating requirements for fiscal 2008 and for the foreseeable future.

At August 2, 2008, the Company had working capital of \$165.8 million compared to \$209.6 million at August 4, 2007. Additionally, the Company had \$2.2 million and \$1.9 million invested in privately managed investment funds at August 2, 2008 and August 4, 2007, respectively, which are included in other assets on the Condensed Consolidated Balance Sheets.

At August 2, 2008, the Company had an unsecured revolving credit agreement, which provided for borrowings of up to \$35 million. The revolving credit agreement is committed until August 2010. The credit agreement contains various financial covenants and limitations, including the maintenance of specific financial ratios with which the Company was in compliance as of August 2, 2008. There were no borrowings outstanding under this credit facility during the first six months ended August 2, 2008 or the fiscal year ended February 2, 2008.

At August 2, 2008 and August 4, 2007, the Company had approximately \$4.8 million and \$6.6 million, respectively, of outstanding irrevocable letters of credit relating to purchase commitments.

Expenditures for property and equipment totaled \$10.5 million in the first six months of fiscal 2008, compared to \$9.6 million in last year's first six months. The expenditures for the first six months of 2008 were primarily for store development and investments in new technology. For the full fiscal 2008 year, the Company is planning to invest approximately \$22.3 million for capital expenditures. This includes expenditures to open 70 new stores and relocate 9 stores.

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**THE CATO CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF
OPERATIONS (CONTINUED)**

LIQUIDITY, CAPITAL RESOURCES AND MARKET RISK (CONTINUED):

Net cash used in investing activities totaled \$26.0 million in the first six months of fiscal 2008 compared to \$61.3 million used in the comparable period of 2007. The decrease was due primarily to the net decrease in purchases over sales of short-term investments.

On August 28, 2008, the Board of Directors maintained the quarterly dividend at \$.165 per share, or an annualized rate of \$.66 per share.

On August 30, 2007, the Board authorized an increase in the Company's share repurchase program of two million shares. There is no specified expiration date by which any shares included in this authorization must be purchased. At August 2, 2008, 394,660 shares remain available for repurchase in open authorizations. No shares were repurchased in the first six months of fiscal 2008.

The Company does not use derivative financial instruments. At August 2, 2008, the Company's investment portfolio was primarily invested in governmental and other debt securities with maturities less than 36 months. These securities are classified as available-for-sale and are recorded on the balance sheet at fair value, with unrealized gains and temporary losses reported net of taxes as accumulated other comprehensive income. Other than temporary declines in fair value of investments are recorded as a reduction in the cost of investments in the accompanying Condensed Consolidated Balance Sheets.

The Company had 76 stores closed due to Hurricane Gustav. The Company is in the process of determining any loss due to damages incurred.

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THE CATO CORPORATION

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK:

The Company is subject to market rate risk from exposure to changes in interest rates based on its financing, investing and cash management activities, but the Company does not believe such exposure is material.

ITEM 4. CONTROLS AND PROCEDURES:

We carried out an evaluation, with the participation of our principal executive officer and principal financial officer, of the effectiveness of our disclosure controls and procedures as of August 2, 2008. Based on this evaluation, our principal executive officer and principal financial officer concluded that, as of August 2, 2008, our disclosure controls and procedures, as defined in Rule 13a-15(e), under the Securities Exchange Act of 1934 (the Exchange Act), were effective to ensure that information we are required to disclose in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

CHANGES IN INTERNAL CONTROL OVER FINANCIAL REPORTING:

No change in the Company's internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) has occurred during the Company's fiscal quarter ended August 2, 2008 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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Not Applicable

ITEM 1A. RISK FACTORS

In addition to the other information in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for our fiscal year ended February 2, 2008. These risks could materially affect our business, financial condition or future results; however, they are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial may also materially and adversely affect our business, financial condition or results of operations.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Not Applicable

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not Applicable

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Following are the results of the matters voted upon and approved at the Company's Annual Meeting which was held on May 22, 2008.

Election of Directors:

	For	Withheld	Voting Power	
			For	Withheld
Mr. Robert W. Bradshaw, Jr.	22,933,323	4,839,103	38,625,048	4,839,103
Mr. Grant L. Hamrick	26,837,554	934,872	42,529,279	934,872

Ratification of Independent Auditor:

For	Against	Abstain	For	Voting Power	
				Against	Abstain
27,738,240	28,573	5,612	43,429,965	28,573	5,612

Amended and Restated 2004 Incentive Compensation Plan:

For	Against	Abstain	Broker Non Vote	For	Voting Power	
					Against	Abstain
26,158,751	808,203	11,187	794,285	41,850,476	808,203	11,187

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PART II OTHER INFORMATION (CONTINUED)

THE CATO CORPORATION

ITEM 5. OTHER INFORMATION

Not Applicable

ITEM 6. EXHIBITS

Exhibit No.	Item
3.1	Registrant's Restated Certificate of Incorporation dated March 6, 1987, incorporated by reference to Exhibit 4.1 to Form S-8 of the Registrant filed February 7, 2000 (SEC File No. 333-96283).
3.2	Registrant's By Laws incorporated by reference to Exhibit 99.2 to Form 8-K of the Registrant filed December 10, 2007.
4.1	Rights Agreement dated December 18, 2003, incorporated by reference to Exhibit 4.1 to Form 8-A12G of the Registrant filed December 22, 2003 and as amended in Form 8-A12B/A filed January 6, 2004.
31.1	Rule 13a-14(a)/15d-14(a) Certification of Principal Executive Officer.
31.2	Rule 13a-14(a)/15d-14(a) Certification of Principal Financial Officer.
32.1	Section 1350 Certification of Principal Executive Officer.
32.2	Section 1350 Certification of Principal Financial Officer.

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**PART II OTHER INFORMATION
THE CATO CORPORATION**

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.

THE CATO CORPORATION

September 10,
2008
Date

/s/ John P. D. Cato
John P. D. Cato
Chairman, President and
Chief Executive Officer

September 10,
2008
Date

/s/ John R. Howe
John R. Howe
Executive Vice President
Chief Financial Officer