

CATO CORP  
Form 10-Q  
June 13, 2007

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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 May 5, 2007

**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 or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-Accelerated filer

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 May 22, 2007, there were 30,987,759 shares of Class A common stock and 690,525 shares of Class B common stock outstanding.



**THE CATO CORPORATION**  
**FORM 10-Q**  
**Quarter Ended May 5, 2007**  
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Exhibit 32.1

Exhibit 32.2

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**THE CATO CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME AND**  
**COMPREHENSIVE INCOME**

|  | <b>Three Months Ended</b>                            |                           |
|--|--|---------------------------|
|  | <b>May 5,<br/>2007</b>                               | <b>April 29,<br/>2006</b> |
|  | <b>(Unaudited)</b>                                   | <b>(Unaudited)</b>        |
|  | <b>(Dollars in thousands, except per share data)</b> |                           |
| <b>REVENUES</b>  |  |                           |
| Retail sales   | \$ 224,134   | \$ 229,741                |
| Other income (principally finance charges, late fees and layaway charges)                      | 3,094  | 3,319                     |
| Total revenues   | 227,228  | 233,060                   |
| <b>COSTS AND EXPENSES, NET</b>   |  |                           |
| Cost of goods sold (exclusive of depreciation shown below)                                     | 143,422  | 142,113                   |
| Selling, general and administrative  | 51,136   | 54,577                    |
| Depreciation   | 5,391  | 5,168                     |
| Interest and other income  | (1,893)  | (1,552)                   |
|  | 198,056  | 200,306                   |
| Income before income taxes   | 29,172   | 32,754                    |
| Income tax expense   | 10,502   | 11,955                    |
| Net Income   | \$ 18,670  | \$ 20,799                 |
| Basic earnings per share   | \$ 0.60  | \$ 0.67                   |
| Basic weighted average shares  | 31,352,592   | 31,084,206                |
| Diluted earnings per share   | \$ 0.59  | \$ 0.65                   |
| Diluted weighted average shares  | 31,897,676   | 31,814,193                |
| Dividends per share  | \$ 0.15  | \$ 0.13                   |
| <b>Comprehensive income:</b>   |  |                           |
| Net income   | \$ 18,670  | \$ 20,799                 |
| Unrealized gains (losses) on available-for-sale securities, net of deferred income tax benefit | 27   | (22)                      |

|                          |    |               |    |        |
|--------------------------|----|---------------|----|--------|
| Net comprehensive income | \$ | <b>18,697</b> | \$ | 20,777 |
|--------------------------|----|---------------|----|--------|

See notes to condensed consolidated financial statements.

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**THE CATO CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

|   | <b>May 5,<br/>2007<br/>(Unaudited)</b> | April 29,<br>2006<br>(Unaudited) | February 3,<br>2007 |
|---|--|----------------------------------|---------------------|
|   | <b>(Dollars in thousands)</b>          |                                  |                     |
| <b>ASSETS</b>   |  |                                  |                     |
| Current Assets:   |  |                                  |                     |
| Cash and cash equivalents   | <b>\$ 21,164</b>                       | \$ 25,319                        | \$ 24,833           |
| Short-term investments  | <b>132,450</b>                         | 95,752                           | 98,709              |
| Accounts receivable, net of allowance for doubtful accounts of \$3,243, \$3,606 and \$3,554 at May 5, 2007, April 29, 2006 and February 3, 2007, respectively   | <b>45,287</b>                          | 47,791                           | 45,958              |
| Merchandise inventories   | <b>117,037</b>                         | 103,145                          | 115,918             |
| Deferred income taxes   | <b>7,489</b>                           | 8,538                            | 7,508               |
| Prepaid expenses  | <b>6,940</b>                           | 2,841                            | 6,587               |
| <b>Total Current Assets</b>   | <b>330,367</b>                         | 283,386                          | 299,513             |
| Property and equipment net  | <b>126,809</b>                         | 131,516                          | 128,461             |
| Other assets  | <b>4,361</b>                           | 10,799                           | 4,348               |
| <b>Total Assets</b>   | <b>\$ 461,537</b>                      | \$ 425,701                       | \$ 432,322          |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |  |                                  |                     |
| Current Liabilities:  |  |                                  |                     |
| Accounts payable  | <b>\$ 90,952</b>                       | \$ 75,641                        | \$ 77,046           |
| Accrued expenses  | <b>29,755</b>                          | 30,089                           | 29,526              |
| Accrued bonus and benefits  | <b>1,065</b>                           | 13,194                           | 10,756              |
| Accrued income taxes  | <b>15,692</b>                          | 16,591                           | 5,721               |
| <b>Total Current Liabilities</b>  | <b>137,464</b>                         | 135,515                          | 123,049             |
| Deferred income taxes   | <b>8,817</b>                           | 9,261                            | 8,817               |
| Other noncurrent liabilities (primarily deferred rent)  | <b>23,298</b>                          | 23,526                           | 23,663              |
| 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 36,082,118 shares, 35,653,816 shares and 35,955,815 shares at May 5, 2007, April 29, 2006 and February 3, 2007, respectively | <b>1,203</b>                           | 1,188                            | 1,199               |
| Convertible Class B common stock, \$.033 par value per share, 15,000,000 shares authorized; issued 690,525 shares, at May 5, 2007, April 29, 2006 and February 3, 2007, respectively                                | <b>23</b>                              | 23                               | 23                  |
| Additional paid-in capital  | <b>43,307</b>                          | 39,743                           | 42,475              |
| Retained earnings   | <b>341,986</b>                         | 311,202                          | 327,684             |



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|   |                   |            |            |
|---|-------------------|------------|------------|
| Accumulated other comprehensive income  | <b>252</b>        | 56         | 225        |
|   | <b>386,771</b>    | 352,212    | 371,606    |
| Less Class A common stock in treasury, at cost (5,093,609 shares at May 5, 2007, April 29, 2006 and February 3, 2007, respectively) | <b>(94,813)</b>   | (94,813)   | (94,813)   |
| Total Stockholders' Equity  | <b>291,958</b>    | 257,399    | 276,793    |
| Total Liabilities and Stockholders' Equity  | <b>\$ 461,537</b> | \$ 425,701 | \$ 432,322 |

See notes to condensed consolidated financial statements.

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**THE CATO CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

|   | <b>Three Months Ended</b>     |                           |
|---|-------------------------------|---------------------------|
|   | <b>May 5,<br/>2007</b>        | <b>April 29,<br/>2006</b> |
|   | <b>(Unaudited)</b>            | <b>(Unaudited)</b>        |
|   | <b>(Dollars in thousands)</b> |                           |
| <b>OPERATING ACTIVITIES</b>   |                               |                           |
| Net income  | \$ 18,670                     | \$ 20,799                 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                               |                           |
| Depreciation  | 5,391                         | 5,168                     |
| Provision for doubtful accounts   | 458                           | 981                       |
| Share-based compensation  | 371                           | 244                       |
| Excess tax benefits from share-based compensation                                 | (62)                          | (80)                      |
| Deferred income taxes   |                               | (12)                      |
| Loss on disposal of property and equipment  | 133                           | 136                       |
| Changes in operating assets and liabilities which provided (used) cash:           |                               |                           |
| Accounts receivable   | 213                           | 872                       |
| Merchandise inventories   | (1,119)                       | 225                       |
| Prepaid and other assets  | (366)                         | (467)                     |
| Accrued income taxes  | 10,396                        | 11,681                    |
| Accounts payable, accrued expenses and other liabilities                          | 4,539                         | (10,739)                  |
| Net cash provided by operating activities   | <b>38,624</b>                 | 28,808                    |
| <b>INVESTING ACTIVITIES</b>   |                               |                           |
| Expenditures for property and equipment   | (3,930)                       | (12,765)                  |
| Purchases of short-term investments   | (158,505)                     | (50,069)                  |
| Sales of short-term investments   | 124,810                       | 40,380                    |
| Net cash used in investing activities   | <b>(37,625)</b>               | (22,454)                  |
| <b>FINANCING ACTIVITIES</b>   |                               |                           |
| Change in cash overdrafts included in accounts payable                            | (400)                         | 805                       |
| Dividends paid  | (4,734)                       | (4,059)                   |
| Proceeds from employee stock purchase plan  | 214                           | 189                       |
| Excess tax benefits from share-based compensation                                 | 62                            | 80                        |
| Proceeds from stock options exercised   | 190                           | 216                       |
| Net cash used in financing activities   | <b>(4,668)</b>                | (2,769)                   |
| Net increase (decrease) in cash and cash equivalents                              | <b>(3,669)</b>                | 3,585                     |
| Cash and cash equivalents at beginning of period                                  | <b>24,833</b>                 | 21,734                    |

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|  |           |           |
|--|-----------|-----------|
| Cash and cash equivalents at end of period | \$ 21,164 | \$ 25,319 |
|--|-----------|-----------|

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 ENDED MAY 5, 2007 AND APRIL 29, 2006**

**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 May 5, 2007 and April 29, 2006 are unaudited. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. 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 3, 2007.

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. The fair values of short-term investments are based on quoted market prices.

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 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 May 24, 2007, the Board of Directors increased the quarterly dividend by 10% from \$.15 per share to \$.165 per share, or an annualized rate of \$.66 per share.

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**THE CATO CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**  
**FOR THE THREE MONTHS ENDED MAY 5, 2007 AND APRIL 29, 2006**

**NOTE 2 EARNINGS PER SHARE:**

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 other convertible securities. Unvested restricted stock is included in the computation of diluted EPS using the treasury stock method.

|  | <b>Three Months Ended</b> |                           |
|--|---------------------------|---------------------------|
|  | <b>May 5,<br/>2007</b>    | <b>April 29,<br/>2006</b> |
| Weighted-average shares outstanding                              | <b>31,352,592</b>         | 31,084,206                |
| Dilutive effect of :   |                           |                           |
| Stock options  | <b>501,653</b>            | 586,610                   |
| Restricted stock   | <b>43,431</b>             | 143,377                   |
| Weighted-average shares and common stock equivalents outstanding | <b>31,897,676</b>         | 31,814,193                |

**NOTE 3 SUPPLEMENTAL CASH FLOW INFORMATION:**

Income tax payments, net of refunds received, for the three months ended May 5, 2007 and April 29, 2006 were \$140,000 and \$277,000, respectively.

**NOTE 4 FINANCING ARRANGEMENTS:**

At May 5, 2007, 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 2008. 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 May 5, 2007. There were no borrowings outstanding under these credit facilities during the first three months ended May 5, 2007 or April 29, 2006, or the fiscal year ended February 3, 2007. Interest on any borrowings is based on LIBOR which was 5.32% at May 5, 2007.

At May 5, 2007 and April 29, 2006 the Company had approximately \$4,501,000 and \$2,236,000, respectively, of outstanding irrevocable letters of credit relating to purchase commitments.

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**THE CATO CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**  
**FOR THE THREE MONTHS ENDED MAY 5, 2007 AND APRIL 29, 2006**

**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 May 5, 2007, 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<br>May 5, 2007 | Retail    | Credit   | Total     |
|-----------------------------------|-----------|----------|-----------|
| Revenues                          | \$224,630 | \$ 2,598 | \$227,228 |
| Depreciation                      | 5,367     | 24       | 5,391     |
| Interest and other income         | (1,893)   |          | (1,893)   |
| Income before taxes               | 28,018    | 1,154    | 29,172    |
| Total assets                      | 395,385   | 66,152   | 461,537   |
| Capital expenditures              | 3,917     | 13       | 3,930     |

| Three Months Ended<br>April 29, 2006 | Retail    | Credit   | Total     |
|--------------------------------------|-----------|----------|-----------|
| Revenues                             | \$230,370 | \$ 2,690 | \$233,060 |
| Depreciation                         | 5,148     | 20       | 5,168     |
| Interest and other income            | (1,552)   |          | (1,552)   |
| Income before taxes                  | 31,977    | 777      | 32,754    |
| Total assets                         | 357,683   | 68,018   | 425,701   |
| Capital expenditures                 | 12,748    | 17       | 12,765    |

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

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

|                  | <b>Three Months Ended</b> |                           |
|------------------|---------------------------|---------------------------|
|                  | <b>May 5,<br/>2007</b>    | <b>April 29,<br/>2006</b> |
| Bad debt expense | \$ 458                    | \$ 981                    |
| Payroll          | 242                       | 252                       |
| Postage          | 278                       | 296                       |
| Other expenses   | 442                       | 364                       |
| Total expenses   | \$ 1,420                  | \$ 1,893                  |

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**THE CATO CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**  
**FOR THE THREE MONTHS ENDED MAY 5, 2007 AND APRIL 29, 2006**

**NOTE 6 STOCK BASED COMPENSATION:**

Effective January 29, 2006, the Company began recording compensation expense associated with stock options and other forms of equity compensation in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 123R, *Share-Based Payment*, as interpreted by SEC Staff Accounting Bulletin No. 107. Prior to January 29, 2006, the Company had accounted for stock options according to the provisions of Accounting Principles Board ( APB ) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations, and therefore no related compensation expense was recorded for awards granted with no intrinsic value at the date of the grant. The Company adopted the modified prospective transition method provided under SFAS No. 123R, and, consequently, has not adjusted results from prior periods to retroactively reflect compensation expense. Under this transition method, compensation cost associated with stock options recognized in fiscal 2006 and 2007 includes quarterly amortization related to the remaining unvested portion of all stock option awards granted prior to January 29, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123.

As of May 5, 2007, 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 Incentive Compensation Plan authorized 1,000,000 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<br>Plan | 1999<br>Plan | 2004<br>Plan | Total     |
|--|--------------|--------------|--------------|-----------|
| Options and/or restricted stock initially authorized | 5,850,000    | 1,000,000    | 1,350,000    | 8,200,000 |
| Options and/or restricted stock available for grant: |              |              |              |           |
| February 3, 2007                                     | 9,277        |              | 1,091,618    | 1,100,895 |
| May 5, 2007  | 9,277        |              | 992,393      | 1,001,670 |

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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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**  
**FOR THE THREE MONTHS ENDED MAY 5, 2007 AND APRIL 29, 2006**

**NOTE 6 STOCK BASED COMPENSATION (CONTINUED):**

The following is a summary of the changes in stock options outstanding during the three months ended May 5, 2007:

|   | Shares    | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value (a) |
|---|-----------|--|---|-------------------------------------|
| Options outstanding at February 3, 2007 | 1,236,675 | \$8.01                                   | 1.86<br>years   | \$18,363,084                        |
| Granted                                 |           |  |   |                                     |
| Forfeited or expired                    | (15,675)  |  |   |                                     |
| Exercised                               | (300)     |  |   |                                     |
| Outstanding at May 5, 2007              | 1,220,700 | \$7.96                                   | 1.57<br>years   | \$17,724,034                        |
| Vested and exercisable at May 5, 2007   | 1,157,900 | \$7.59                                   | 1.26<br>years   | \$17,243,726                        |

- (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 2006 or the first quarter of fiscal 2007.

As of May 5, 2007, there was approximately \$262,000 of total unrecognized compensation cost related to nonvested options, which is expected to be recognized over a remaining weighted-average vesting period of 2.18 years. The total intrinsic value of options exercised during the first quarter ended May 5, 2007 was approximately \$172,000.

Effective with the adoption of FAS 123R, the Company began recognizing share-based compensation expense ratably over the vesting period, net of estimated forfeitures. The Company recognized share-based compensation expense of \$375,000 and \$244,000 for the first quarter ended May 5, 2007 and April 29, 2006, respectively, which was classified as a component of selling, general and administrative expenses.



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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**  
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**NOTE 6 STOCK BASED COMPENSATION (CONTINUED):**

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 three months ended May 5, 2007 and April 29, 2006, the Company reported \$62,000 and \$80,000 of excess tax benefits as a financing cash inflow in addition to \$404,000 and \$405,000 in cash proceeds received from the exercise of stock options and Employee Stock Purchase Plan purchases, respectively.

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 three months ended

May 5, 2007 and April 29, 2006, the Company sold 11,403 shares and 11,075 shares to employees at an average discount of \$3.31 and \$3.01 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 \$38,000 and \$33,000 for the three months ended May 5, 2007 and April 29, 2006, 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 net of estimated forfeitures. As of May 5, 2007 and April 29, 2006, there was \$6,234,123 and \$57,000 of total unrecognized compensation cost related to nonvested restricted stock awards, which is expected to be recognized over a remaining weighted-average vesting period of 4.3 years and 0.1 years, respectively. The total fair value of the shares recognized as compensation expense during the first quarter ended May 5, 2007 and April 29, 2006 was \$302,000 and \$171,000, respectively.

The following summary shows the changes in the shares of restricted stock outstanding during the three months ended May 5, 2007:

|  | Number of<br>Shares | Weighted<br>Average<br>Grant Date Fair<br>Value Per Share |
|--|---------------------|---|
| Vested and exercisable at February 3, 2007 | 214,882             | \$ 22.92  |
| Granted                                    | 99,885              | 21.87   |
| Vested                                     |                     | N/A   |
| Forfeited or expired                       | (660)               | 22.89   |
| Outstanding at May 5, 2007                 | 314,107             | \$ 22.59  |

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**THE CATO CORPORATION  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)  
FOR THE THREE MONTHS ENDED MAY 5, 2007 AND APRIL 29, 2006**

**NOTE 7 INCOME TAXES:**

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109. This Interpretation prescribes the recognition threshold a tax position is required to meet before being recognized in the financial statements. The Interpretation also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods and disclosure of uncertain tax positions. The Interpretation is effective for fiscal years beginning after December 15, 2006. The Company adopted Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, on February 4, 2007. As a result of the implementation of FASB Interpretation No. 48, the Company recognized a transition adjustment increasing beginning retained earnings by \$362,000. At May 5, 2007, we had \$6,600,000 of unrecognized tax benefits, \$4,500,000 of which would affect the effective tax rate if recognized. The Company recognizes interest and penalties related to uncertain tax positions in income tax expense. As of May 5, 2007, we had approximately \$4,000,000 of accrued interest and penalties related to uncertain tax positions. The tax years after 2003 remain open to examination by the major taxing jurisdictions to which the Company is subject.

**NOTE 8 RECENT ACCOUNTING PRONOUNCEMENTS:**

In September 2006, 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. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements and, accordingly does not require any new fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is in the process of evaluating the impact that the adoption of SFAS 157 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 2007 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 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 3, 2007 (fiscal 2006), 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.

As used herein, the terms we, our, us (or similar terms), the Company or Cato include The Cato Corporation subsidiaries, except that when used with reference to common stock or other securities described herein and in describing the positions held by management of the Company, such terms include only The Cato Corporation. Our website is located at [www.catocorp.com](http://www.catocorp.com). We make available free of charge, through our website, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements and other reports (including amendments to these reports) filed or furnished pursuant to Section 13(a) or 15(d) under the Securities Exchange Act of 1934. These reports are available as soon as reasonably practicable after we electronically file those materials with the SEC. We also post on our website the charters of our Audit, Compensation and Corporate Governance and Nominating Committees; our Corporate Governance Guidelines, Code of Business Conduct and Ethics; and any amendments or waivers thereto; and any other corporate governance materials contemplated by SEC or New York Stock Exchange regulations. The documents are also available in print to any shareholder who requests by contacting our corporate secretary at our Company offices at 8100 Denmark Road, Charlotte, North Carolina 28273-5975.

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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. 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 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:

|                                     | <b>Three Months Ended</b> |                   |
|-------------------------------------|---------------------------|-------------------|
|                                     | <b>May 5,<br/>2007</b>    | April 29,<br>2006 |
| Total retail sales                  | <b>100.0%</b>             | 100.0%            |
| Total revenues                      | <b>101.4</b>              | 101.5             |
| Cost of goods sold                  | <b>64.0</b>               | 61.8              |
| Selling, general and administrative | <b>22.8</b>               | 23.8              |
| Depreciation                        | <b>2.4</b>                | 2.3               |
| Interest and other income           | <b>(0.8)</b>              | (0.7)             |
| Income before income taxes          | <b>13.0</b>               | 14.3              |
| Net income                          | <b>8.3</b>                | 9.1               |

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MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL  
CONDITION AND RESULTS OF OPERATIONS (CONTINUED)****RESULTS OF OPERATIONS (CONTINUED):****Comparison of First Quarter of 2007 with 2006.**

Total retail sales for the first quarter were \$224.1 million compared to last year's first quarter sales of \$229.7 million, a 2% decrease. Same-store sales declined 5% in the first quarter of fiscal 2007 compared to the first quarter of fiscal 2006. Total revenues, comprised of retail sales and other income (principally, finance charges and late fees on customer accounts receivable and layaway fees), were \$227.2 million for the first quarter ended May 5, 2007 compared to \$233.1 million for the first quarter ended April 29, 2006. The Company operated 1,286 stores at May 5, 2007 compared to 1,252 stores at the end of last year's first quarter. In the first quarter of fiscal 2007, the Company opened 10 stores and relocated 6 stores. The Company plans to open approximately 80 stores and close approximately 10 stores during fiscal 2007.

Credit revenue of \$2.6 million represented 1.1% of total revenues in the first quarter of fiscal 2007, compared to 2006 credit revenue of \$2.7 million or 1.2% of total revenues. The reduction in credit revenue was due to lower finance charge and late fee income from lower sales under the Company's proprietary credit card and 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 first quarter of 2007 compared to last year's first quarter expenses of \$1.9 million. The decrease in costs was principally due to lower bad debt expense.

Other income in total, as included in total revenues was \$3.1 million for the first quarter of fiscal 2007, compared to \$3.3 million for the prior year's comparable first quarter. The decrease resulted primarily from lower finance charges and late fee income.

Cost of goods sold was \$143.4 million, or 64.0% of retail sales for the first quarter of fiscal 2007, compared to \$142.1 million, or 61.8% of retail sales in the first quarter of fiscal 2006. The overall increase in cost of goods sold as a percent of retail sales for the first quarter of fiscal 2007 resulted primarily from higher markdowns and occupancy costs, partially offset by lower procurement costs. The reduction in procurement cost was primarily the result of increased direct sourcing. The increase in markdowns was primarily attributable to lower 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. 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)

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

**RESULTS OF OPERATIONS (CONTINUED):**

decreased by 7.9% to \$80.7 million for the first quarter of fiscal 2007 compared to \$87.6 million in the first quarter of fiscal 2006. 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 \$51.1 million, or 22.8% of retail sales for the first quarter of fiscal 2007, compared to \$54.6 million, or 23.8% of retail sales in the first quarter of fiscal 2006. SG&A expenses as a percentage of retail sales decreased 100 basis points for the first quarter of fiscal 2007 as compared to the prior year. The decline in SG&A expenses as a percentage of retail sales for the first quarter of fiscal 2007 was primarily attributable to a decrease in incentive based compensation expenses. The overall dollar decrease in SG&A expenses for the first quarter of fiscal 2007 resulted primarily from decreased incentive based compensation expenses, legal fees and bad debts.

Depreciation expense was \$5.4 million, or 2.4% of retail sales for the first quarter of fiscal 2007, compared to \$5.2 million, or 2.3% of retail sales in the first quarter of fiscal 2006.

Interest and other income was \$1.9 million, or 0.8% of retail sales for the first quarter of fiscal 2007, compared to \$1.6 million, or 0.7% of retail sales for the first quarter of fiscal 2006. The increase in the first quarter of fiscal 2007 resulted primarily from higher interest rates and higher balances.

Income tax expense was \$10.5 million or 4.7% of retail sales for the first quarter of fiscal 2007, compared to \$12.0 million, or 5.2% of retail sales for the first quarter of fiscal 2006. The first quarter decrease resulted from lower pre-tax income and a lower effective tax rate. The effective income tax rate for the first quarter of fiscal 2007 was 36.0% compared to 36.5% for the first quarter of fiscal 2006.

**LIQUIDITY, CAPITAL RESOURCES AND MARKET RISK:**

The Company has consistently maintained a strong liquidity position. Cash provided by operating activities during the first three months of fiscal 2007 was \$38.6 million as compared to \$28.8 million in the first three months of fiscal 2006. 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 \$35 million of unsecured revolving credit facilities for short-term financing of seasonal cash needs. There were no outstanding borrowings on these facilities at May 5, 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 (CONTINUED):**

Cash provided by operating activities for the first three months of fiscal 2007 was primarily generated by earnings adjusted for depreciation and changes in working capital. The increase of \$9.8 million for the first three months of fiscal 2007 as compared to the first three months of fiscal 2006 was primarily due to an increase in accounts payables in fiscal 2007 compared to a reduction in accounts payable in fiscal 2006, offset by lower net income and a smaller increase in accrued income taxes in fiscal 2007.

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, purchase of treasury stock and other operating requirements for fiscal 2007 and for the foreseeable future.

At May 5, 2007, the Company had working capital of \$192.9 million compared to \$147.9 million at April 29, 2006. Additionally, the Company had \$1.9 million invested in privately managed investment funds at May 5, 2007, which are included in other assets on the Condensed Consolidated Balance Sheets.

At May 5, 2007, the Company had an unsecured revolving credit agreement, which provides for borrowings of up to \$35 million. The revolving credit agreement is committed until August 2008. 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 May 5, 2007. There were no borrowings outstanding under these credit facilities during the first quarter ended May 5, 2007 or the fiscal year ended February 3, 2007.

At May 5, 2007 and April 29, 2006, the Company had approximately \$4.5 million and \$2.2 million, respectively, of outstanding irrevocable letters of credit relating to purchase commitments.

Expenditures for property and equipment totaled \$3.9 million in the first quarter of fiscal 2007, compared to \$12.8 million in last year's first fiscal quarter. The expenditures for the first three months of 2007 were primarily for the development of 10 new stores, relocating 6 stores, and additional investments in new technology. In fiscal 2007, the Company is planning to invest approximately \$24.0 to \$27.0 million for capital expenditures. This includes expenditures to open 80 new stores, relocate 20 stores and remodel 15 stores.

Net cash used in investing activities totaled \$37.6 million in the first quarter of fiscal 2007 compared to \$22.5 million used for the comparable period of 2006. The increase was due primarily to the net increase in purchases over sales of short-term investments.

On May 24, 2007, the Board of Directors increased the quarterly dividend by 10% from \$.15 per share to \$.165 per share, or an annualized rate of \$.66 per share.

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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):**

The Company does not use derivative financial instruments. At May 5, 2007, 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.



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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 May 5, 2007. Based on this evaluation, our principal executive officer and principal financial officer concluded that, as of May 5, 2007, 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 May 5, 2007 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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**PART II OTHER INFORMATION  
THE CATO CORPORATION**

**ITEM 1. LEGAL PROCEEDINGS**

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 3, 2007. 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 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**

Not Applicable

**ITEM 5. OTHER INFORMATION**

Not Applicable

**ITEM 6. EXHIBITS**

| Exhibit No. | Item   |
|-------------|--|
| 10.1        | Separation and Confidentiality Agreement and General Release, between the Registrant and Reynolds C. Faulkner, dated April 18, 2007. |
| 31.1        | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer.   |
| 31.2        | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer.   |
| 32.1        | Section 1350 Certification of Chief Executive Officer.   |
| 32.2        | Section 1350 Certification of Chief 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

June 13, 2007

/s/ John P. D. Cato

Date

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

June 13, 2007

/s/ Thomas W. Stoltz

Date

Thomas W. Stoltz  
Executive Vice President  
Chief Financial Officer

June 13, 2007

/s/ John R. Howe

Date

John R. Howe  
Senior Vice President  
Controller