

CATO CORP
Form 10-K
April 01, 2008

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

Form 10-K

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

For the fiscal year ended February 2, 2008

or

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

Commission File Number 1-31340

The Cato Corporation
Registrant

Delaware
State of Incorporation

56-0484485
*I.R.S. Employer
Identification Number*

8100 Denmark Road
Charlotte, North Carolina 28273-5975
Address of Principal Executive Offices

704/554-8510
Registrant's Telephone Number

Securities registered pursuant to Section 12(b) of the Act:

Class A Common Stock
Preferred Share Purchase Rights

New York Stock Exchange
New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

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, if disclosure of delinquent filers pursuant to Item 405 of the Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 Exchange Act Rule 12b-2). Yes No

The aggregate market value of the Registrant's Class A Common Stock held by non-affiliates of the Registrant as of August 3, 2007, the last business day of the Company's most recent second quarter, was \$634,351,746 based on the last reported sale price per share on the New York Stock Exchange on that date.

As of March 25, 2008, there were 27,649,013 shares of Class A Common Stock and 1,743,525 shares of Convertible Class B Common Stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the proxy statement relating to the 2008 annual meeting of shareholders are incorporated by reference into the following part of this annual report:

Part III Items 10, 11, 12, 13 and 14

THE CATO CORPORATION

FORM 10-K

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Forward-looking Information

The following information should be read along with the Consolidated Financial Statements, including the accompanying Notes appearing later 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 Annual Report on Form 10-K 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 Business, Properties, Legal Proceedings, Controls and Procedures and 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 variations of such 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 this 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.

As used herein, the terms we, our, us (or similar terms), the Company or Cato include The Cato Corporation and its 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 where we make available free of charge, 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.

PART I

Item 1. *Business:*

General

The Company, founded in 1946, operated 1,318 women's fashion specialty stores at February 2, 2008, in 32 states, principally in the southeastern United States, under the names Cato, Cato Fashions, Cato Plus, It's Fashion, and Fashion Metro. The Company seeks to offer quality fashion apparel and accessories at low prices, every day in junior/missy, plus sizes and girls sizes 7 to 16. The Company's stores feature a broad assortment of apparel and accessories, including dressy, career, and casual sportswear, dresses, coats, shoes, lingerie, costume jewelry and handbags. A major portion of the Company's merchandise is sold under its private label and is produced by various vendors in accordance with the Company's specifications. Most stores range in size from 3,500 to 6,000 square feet and are located primarily in strip shopping centers anchored by national discounters or market-dominant grocery stores. The Company emphasizes friendly customer service and coordinated merchandise presentations in an appealing store environment. The Company offers its own credit card and layaway plan. Credit and layaway sales represented 11% of retail sales in fiscal 2007. See Note 14 to the Consolidated Financial Statements, Reportable Segment Information for a discussion of information regarding the Company's two reportable segments: retail and credit.

Business

The Company's primary objective is to be the leading fashion specialty retailer for fashion and value conscious females in its markets. Management believes the Company's success is dependent upon its ability to differentiate its stores from department stores, mass merchandise discount stores and competing women's specialty stores. The key elements of the Company's business strategy are:

Merchandise Assortment. The Company's stores offer a wide assortment of on-trend apparel and accessory items in junior/missy, plus sizes and girls sizes 7 to 16 and emphasize color, product coordination and selection. Colors and styles are coordinated and presented so that outfit selection is easily made.

Value Pricing. The Company offers quality merchandise that is generally priced below comparable merchandise offered by department stores and mall specialty apparel chains, but is generally more fashionable than merchandise offered by discount stores. Management believes that the Company has positioned itself as the everyday low price leader in its market segment.

Strip Shopping Center Locations. The Company locates its stores principally in convenient strip centers anchored by national discounters or market-dominant grocery stores that attract large numbers of potential customers.

Customer Service. Store managers and sales associates are trained to provide prompt and courteous service and to assist customers in merchandise selection and wardrobe coordination.

Credit and Layaway Programs. The Company offers its own credit card and a layaway plan to make the purchase of its merchandise more convenient for its customers.

Expansion. The Company plans to continue to expand into northern, midwestern and southwestern adjacent states, as well as to fill-in its existing southeastern core geography.

Merchandising

Merchandising

The Company seeks to offer a broad selection of high quality and exceptional value apparel and accessories to suit the various lifestyles of fashion and value conscious females. In addition, the Company strives to offer on-trend fashion in exciting colors with consistent fit and quality.

The Company's merchandise lines include dressy, career, and casual sportswear, dresses, coats, shoes, lingerie, costume jewelry and handbags. The Company primarily offers exclusive merchandise with fashion and quality comparable to mall specialty stores at low prices, every day.

The Company believes that the collaboration of its merchandising team with an expanded in-house product development and direct sourcing function has enhanced merchandise offerings and delivers quality exclusive on-trend styles at lower prices. The product development and direct sourcing operations provide research on emerging fashion and color trends, technical services and direct sourcing options.

As a part of its merchandising strategy, members of the Company's merchandising staff frequently visit selected stores, monitor the merchandise offerings of other retailers, regularly communicate with store operations associates and frequently confer with key vendors. The Company also takes aggressive markdowns on slow-selling merchandise and does not carry over merchandise to the next season.

Purchasing, Allocation and Distribution

Although the Company purchases merchandise from approximately 1,500 suppliers, most of its merchandise is purchased from approximately 100 primary vendors. In fiscal 2007, purchases from the Company's largest vendor accounted for approximately 4% of the Company's total purchases. No other vendor accounted for more than 3% of total purchases. The Company is not dependent on its largest vendor or any other vendor for merchandise purchases, and the loss of any single vendor or group of vendors would not have a material adverse effect on the Company's operating results or financial condition. A substantial portion of the Company's merchandise is sold under its private labels and is produced by various vendors in accordance with the Company's strict specifications. The Company purchases most of its merchandise from domestic importers and vendors, which typically minimizes the time necessary to purchase and obtain shipments in order to enable the Company to react to merchandise trends in a more timely fashion. Although a significant portion of the Company's merchandise is manufactured overseas, principally in the Far East, the Company does not expect that any economic, political or social unrest in any one geographic region would have a material adverse effect on the Company's ability to obtain adequate supplies of merchandise. However, the Company can give no assurance that any changes or disruptions in its merchandise supply chain would not materially and adversely affect the Company. See Risk Factors Risks Relating To Our Business Changes or other disruptions in the Company's merchandise supply chain including those affecting the importation of goods from the foreign markets that supply a significant amount of the Company's merchandise, could materially and adversely affect the Company's costs and results of operations.

An important component of the Company's strategy is the allocation of merchandise to individual stores based on an analysis of sales trends by merchandise category, customer profiles and climatic conditions. A merchandise control system provides current information on the sales activity of each merchandise style in each of the Company's stores. Point-of-sale terminals in the stores collect and transmit sales and inventory information to the Company's central database, permitting timely response to sales trends on a store-by-store basis.

All merchandise is shipped directly to the Company's distribution center in Charlotte, North Carolina, where it is inspected and then allocated by the merchandise distribution staff for shipment to individual stores. The flow of merchandise from receipt at the distribution center to shipment to stores is controlled by an on-line system. Shipments are made by common carrier, and each store receives at least one shipment per week. The centralization of the Company's distribution process also subjects it to risks in the event of damage to or destruction of its distribution facility or other disruptions affecting the distribution center or the flow of goods into or out of Charlotte, North Carolina generally. See Risk Factors Risks Relating To Our Business A disruption or shutdown of our centralized distribution center could materially and adversely affect our business and results of operations.

Advertising

The Company uses radio, television, in store signage, graphics and a Company website as its primary advertising media. The Company's total advertising expenditures were approximately .8% of retail sales in fiscal 2007.

Store Operations

The Company's store operations management team consists of 1 director of stores, 4 territorial managers, 16 regional managers and 141 district managers. Regional managers receive a salary plus a bonus based on achieving targeted goals for sales, payroll, shrinkage control and store profitability. District managers receive a salary plus a bonus based on achieving targeted objectives for district sales increases and shrinkage control. Stores are staffed with a manager, two assistant managers and additional part-time sales associates depending on the size of the store and seasonal personnel needs. Store managers receive a salary and all other store personnel are paid on an hourly basis. Store managers, assistant managers and sales associates are eligible for monthly and semi-annual bonuses based on achieving targeted goals for their store's sales increases and shrinkage control.

The Company constantly strives to improve its training programs to develop associates. Over 80% of store and field management are promoted from within, allowing the Company to internally staff an expanding store base. The Company has training programs at each level of store operations. New store managers are trained in training stores managed by experienced associates who have achieved superior results in meeting the Company's goals for store sales, payroll expense and shrinkage control. The type and extent of district manager training varies depending on whether the district manager is promoted from within or recruited from outside the Company.

Store Locations

Most of the Company's stores are located in the southeastern United States in a variety of markets ranging from small towns to large metropolitan areas with trade area populations of 20,000 or more and average approximately 3,900 square feet in size.

All of the Company's stores are leased. Approximately 95% are located in strip shopping centers and 5% in enclosed shopping malls. The Company locates stores in strip shopping centers anchored by a national discounter, primarily Wal-Mart Supercenters or market-dominant grocery stores. The Company's strip center locations provide ample parking and shopping convenience for its customers.

The Company's store development activities consist of opening new stores in new and existing markets, and relocating selected existing stores to more desirable locations in the same market area. The following table sets forth information with respect to the Company's development activities since fiscal 2003.

Store Development

| Fiscal Year | Number of Stores | | | Number of Stores End of Year |
|-------------|-------------------|---------------|---------------|------------------------------|
| | Beginning of Year | Number Opened | Number Closed | |
| 2003 | 1,022 | 87 | 7 | 1,102 |
| 2004 | 1,102 | 80 | 5 | 1,177 |
| 2005 | 1,177 | 82 | 15 | 1,244 |
| 2006 | 1,244 | 58 | 26 | 1,276 |
| 2007 | 1,276 | 62 | 20 | 1,318 |

In fiscal 2007 the Company relocated 18 stores and remodeled 9 stores.

In fiscal 2008 the Company plans to open approximately 75 new stores, relocate 15 stores, close 32 stores, and remodel 15 stores. The expected store openings for 2008 include 30 new stores of an expanded version of the Company's It's Fashion division stores, eight of which will be conversions of current It's Fashion stores which are also included in the planned store closings. The expanded store, operating under the name It's Fashion Metro, currently has six stores open and is a value-priced fashion format offering the latest styles for the entire family including urban-inspired, nationally recognized brands at everyday low prices.

The Company periodically reviews its store base to determine whether any particular store should be closed based on its sales trends and profitability. The Company intends to continue this review process to close underperforming stores. The 20 stores closed in fiscal 2007 were not material to the Company's results of operations.

Credit and Layaway

Credit Card Program

The Company offers its own credit card, which accounted for 7.6%, 7.9% and 8.4% of retail sales in fiscal 2007, 2006 and 2005, respectively. The Company's net bad debt expense was 4.9%, 4.1% and 7.2% of credit sales in fiscal 2007, 2006 and 2005, respectively.

Customers applying for the Company's credit card are approved for credit if they have a satisfactory credit record. Customers are required to make minimum monthly payments based on their account balances. If the balance is not paid in full each month, the Company assesses the customer a finance charge. If payments are not received on time, the customer is assessed a late fee.

Layaway Plan

Under the Company's layaway plan, merchandise is set aside for customers who agree to make periodic payments. The Company adds a nonrefundable administrative fee to each layaway sale. If no payment is made for four weeks, the customer is considered to have defaulted, and the merchandise is returned to the selling floor and again offered for sale, often at a reduced price. All payments made by customers who subsequently default on their layaway purchase are returned to the customer upon request, less the administrative fee and a restocking fee. The Company defers recognition of layaway sales and its related fees to the accounting period when the customer picks up layaway merchandise. Layaway sales represented approximately 3.3%, 3.8% and 4.6% of retail sales in fiscal 2007, 2006 and 2005, respectively.

Management Information Systems

The Company's systems provide daily financial and merchandising information that is used by management to enhance the timeliness and effectiveness of purchasing and pricing decisions. Management uses a daily report comparing actual sales with planned sales and a weekly ranking report to monitor and control purchasing decisions. Weekly reports are also produced which reflect sales, weeks of supply of inventory and other critical data by product categories, by store and by various levels of responsibility reporting. Purchases are made based on projected sales but can be modified to accommodate unexpected increases or decreases in demand for a particular item.

Sales information is projected by merchandise category and, in some cases, is further projected and actual performance measured by stock keeping unit (SKU). Merchandise allocation models are used to distribute merchandise to individual stores based upon historical sales trends, climatic differences, customer demographic differences and targeted inventory turnover rates.

Competition

The women's retail apparel industry is highly competitive. The Company believes that the principal competitive factors in its industry include merchandise assortment and presentation, fashion, price, store location and customer service. The Company competes with retail chains that operate similar women's apparel specialty stores. In addition, the Company competes with mass merchandise chains, discount store chains and major department stores. The Company expects its stores in larger cities and metropolitan areas to face more intense competition.

Seasonality

Due to the seasonal nature of the retail business, the Company has historically experienced and expects to continue to experience seasonal fluctuations in its revenues, operating income and net income. A disproportionate amount of the Company's revenues and a substantial amount of the Company's operating and net income are realized during the first and fourth quarters. Results of a period shorter than a full year may not be indicative of results expected for the entire year. Furthermore, the seasonal nature of our business may affect comparisons between periods.

Regulation

A variety of laws affect the revolving credit program offered by the Company. The Federal Consumer Credit Protection Act (Truth-in Lending) and Regulation Z promulgated thereunder require written disclosure of information relating to such financing, including the amount of the annual percentage rate and the finance charge. The Federal Fair Credit Reporting Act also requires certain disclosures to potential customers concerning credit information used as a basis to deny credit. The Federal Equal Credit Opportunity Act and Regulation B promulgated thereunder prohibit discrimination against any credit applicant based on certain specified grounds. The Federal Trade Commission has adopted or proposed various trade regulation rules dealing with unfair credit and collection practices and the preservation of consumers' claims and defenses. The Company is also subject to the U.S. Patriot Act and the Bank Secrecy Act, which require the Company to monitor account holders and account transactions, respectively. Additionally, the Gramm-Leach-Bliley Act requires the Company to disclose, initially and annually, to its customers, the Company's privacy policy as it relates to a customer's non-public personal information.

Associates

As of February 2, 2008, the Company employed approximately 9,800 full-time and part-time associates. The Company also employs additional part-time associates during the peak retailing seasons. The Company is not a party to any collective bargaining agreements and considers its associate relations to be good.

Item 1A. Risk Factors:

An investment in our common stock involves numerous types of risks. You should carefully consider the following risk factors, in addition to the other information contained in this report, including the disclosures under "Forward Looking Information" above in evaluating our Company and any potential investment in our common stock. If any of the following risks or uncertainties occurs, our business, financial condition and operating results could be materially and adversely affected, the trading price of our common stock could decline and you could lose all or a part of your investment in our common stock. The risks and uncertainties described in this section are not the only ones facing us. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also materially and adversely affect our business operating results and financial condition.

Risks Relating To Our Business:

If we are unable to anticipate, identify and respond to rapidly changing fashion trends and customer demands in a timely manner, our business and results of operations could materially suffer.

Customer tastes and fashion trends, particularly for women's apparel, are volatile and tend to change rapidly. Our success depends in part upon our ability to anticipate and respond to changing merchandise trends and consumer preferences in a timely manner. Accordingly, any failure by us to anticipate, identify and respond to changing fashion trends could adversely affect consumer acceptance of our merchandise, which in turn could adversely affect our business and our image with our customers. If we miscalculate either the market for our merchandise or our customers' tastes or purchasing habits, we may be required to sell a significant amount of unsold inventory at below average markups over cost, or below cost, which would adversely affect our margins and results of operations.

Unusual weather, natural disasters or similar events may adversely affect our sales or operations.

Extreme changes in weather patterns or natural disasters can influence customer trends and shopping habits. For example, heavy rainfall or other extreme weather conditions over a prolonged period might make it difficult for our customers to travel to our stores and thereby reduce our sales and profitability. Our business is also susceptible to

unseasonable weather conditions. For example, extended periods of unseasonably warm temperatures during the winter season or cool weather during the summer season could render a portion of our inventory incompatible with those unseasonable conditions. Reduced sales from extreme or prolonged unseasonable weather conditions would adversely affect our business. Extreme weather patterns, natural disasters, power outages, terrorist acts or other catastrophic events could reduce customer traffic in our stores and likewise disrupt our ability to conduct operations, which could materially and adversely affect us.

Changes or other disruptions in the Company's merchandise supply chain, including those affecting the pricing or importation of goods from the foreign markets that supply a significant amount of the Company's merchandise, could materially and adversely affect the Company's costs and results of operations.

A significant amount of our merchandise is manufactured overseas, principally in the Far East. As a result, political instability or other events resulting in the disruption of trade from other countries or the imposition of additional regulations relating to or duties on imports could cause significant delays or interruptions in the supply of our merchandise or increase our costs, either of which could have a material adverse effect on our business. If we are forced to source merchandise from other countries, those goods may be more expensive or of a different or inferior quality from the ones we now sell. If we were not able to timely or adequately replace the merchandise we currently source with merchandise produced elsewhere, our business could be adversely affected.

Our costs are affected by foreign currency fluctuations.

Because we purchase a significant portion of our inventory from foreign suppliers, our cost of these goods is affected by the fluctuation of the local currencies where these goods are produced against the dollar. Accordingly, changes in the value of the dollar relative to foreign currencies may increase our cost of goods sold and, if we are unable to pass such cost increases on to our customers, decrease our gross margins and ultimately our earnings. Accordingly, foreign currency fluctuations may have a material adverse effect on our business, financial condition and results of operations.

An actual or perceived decline in general economic conditions or outlook may reduce consumer demand for our apparel and accessories.

Consumer spending habits, including spending for our apparel and accessories, are affected by, among other things, prevailing economic conditions, levels of employment, fuel and energy costs, salaries and wage rates, tax rates, the availability of consumer credit, consumer confidence generally or consumer perceptions of economic conditions or trends. A general slowdown in the United States economy or a negative or uncertain economic outlook may adversely affect consumer spending habits, which may result in lower net sales. Numerous events, whether or not related to actual economic conditions, such as downturns in the stock markets, acts of war or terrorism, political unrest or natural disasters, or similar events, may dampen consumer confidence, and accordingly lead to reduced consumer spending. A prolonged economic downturn or loss of consumer confidence could have a material adverse effect on our business, results of operations and financial condition.

A disruption or shutdown of our centralized distribution center could materially and adversely affect our business and results of operations.

The distribution of our products is centralized in one distribution center in Charlotte, North Carolina. The merchandise we purchase is shipped directly to our distribution center where it is prepared for shipment to the appropriate stores. If the distribution center were to be shut down or lose significant capacity for any reason, our operations would likely be seriously disrupted. Such problems could occur as the result of any loss, destruction or impairment of our ability to use our distribution center, as well as any broader problem generally affecting the ability to ship goods into or out of the Charlotte metropolitan area. As a result, we could incur significantly higher costs and longer lead times associated with distributing our products to our stores during the time it takes for us to reopen or replace the distribution center.

A delay in the successful opening of the number of new stores we have planned could adversely affect our business and results of operations.

Our ability to open and operate new stores depends on many factors including our ability to identify suitable store locations, negotiate acceptable lease terms, and hire and train appropriate store personnel. In addition, we continue to

expand our operations to new regions of the country where we have not done business before. This expansion may present new challenges in competition, distribution and merchandising as we enter these new markets.

Risks Relating To Our Common Stock:

Our operating results are subject to seasonal and quarterly fluctuations, which could adversely affect the market price of our common stock.

Our business varies with general seasonal trends that are characteristic of the retail apparel industry. As a result, our stores typically generate a higher percentage of our annual net sales and profitability in the first quarter of our fiscal year compared to other quarters. Such seasonal and quarterly fluctuations could adversely affect the market price of our common stock.

The interests of a principal shareholder may limit the ability of other shareholders to influence the direction of the Company.

As of March 25, 2008, John P. D. Cato, Chairman, President and Chief Executive Officer, beneficially controlled approximately 39% of the voting power of our common stock. As a result, Mr. Cato may be able to control or significantly influence substantially all matters requiring approval by the shareholders, including the election of directors and the approval of mergers and other business combinations. Mr. Cato may have interests that differ from those of other shareholders, and may vote in a way with which other shareholders disagree or perceive as adverse to their interests. In addition, the concentration of voting power held by Mr. Cato could have the effect of preventing, discouraging or deferring a change in control of the Company, which could depress the market price of our common stock.

Item 1B. Unresolved Staff Comments:

None

Item 2. Properties:

The Company's distribution center and general offices are located in a Company-owned building of approximately 492,000 square feet located on a 15-acre tract in Charlotte, North Carolina. The Company's automated merchandise handling and distribution activities occupy approximately 418,000 square feet of this building and its general offices and corporate training center are located in the remaining 74,000 square feet. A building of approximately 24,000 square feet located on a 2-acre tract adjacent to the Company's existing location is used for receiving and staging shipments prior to processing.

Substantially all of the Company's retail stores are leased from unaffiliated parties. Most of the leases have an initial term of five years, with two to three five-year renewal options. Many of the leases provide for fixed rentals plus a percentage of sales in excess of a specified volume.

Item 3. Legal Proceedings:

From time to time, claims are asserted against the Company arising out of operations in the ordinary course of business. The Company currently is not a party to any pending litigation that it believes is likely to have a material adverse effect on the Company's financial position or results of operations and cash flows.

Item 4. Submission of Matters to a Vote of Security Holders:

None.

Item 4A. Executive Officers of the Registrant:

The executive officers of the Company and their ages as of March 25, 2008 are as follows:

| Name | Age | Position |
|--------------------|------------|---|
| John P. D. Cato | 57 | Chairman, President and Chief Executive Officer |
| Michael T. Greer | 45 | Executive Vice President, Director of Stores |
| Howard A. Severson | 60 | Executive Vice President, Chief Real Estate and Store Development Officer |
| Thomas W. Stoltz | 47 | Executive Vice President, Chief Financial Officer |
| Stuart L. Uselton | 47 | Executive Vice President, Chief Administrative Officer |
| B. Allen Weinstein | 61 | Executive Vice President, Chief Merchandising Officer |

John P. D. Cato has been employed as an officer of the Company since 1981 and has been a director of the Company since 1986. Since January 2004, he has served as Chairman, President and Chief Executive Officer. From May 1999 to January 2004, he served as President, Vice Chairman of the Board and Chief Executive Officer. From June 1997 to May 1999, he served as President, Vice Chairman of the Board and Chief Operating Officer. From August 1996 to June 1997, he served as Vice Chairman of the Board and Chief Operating Officer. From 1989 to 1996, he managed the Company's off-price division, serving as Executive Vice President and as President and General Manager of the It's Fashion! Division from 1993 to August 1996. Mr. John Cato is currently a director of Ruddick Corporation.

Michael T. Greer has been employed by the Company since 1985. Since May 2006, he has served as Executive Vice President, Director of Stores of the Company. From November 2004, until May 2006, he served as Senior Vice President, Director of Stores of the Company. From February 2004 until November 2004, he served as Senior Vice President, Director of Stores of the Cato Division. From 2002 to 2003 Mr. Greer served as Vice President, Director of Stores of the It's Fashion! Division. From 1999 to 2001 he served as Territorial Vice President of Stores of the Cato Division and from 1996 to 1999 he served as Regional Vice President of Stores of the Cato Division. From 1985 to 1995, Mr. Greer held various store operational positions in the Cato Division.

Howard A. Severson has been employed by the Company since 1985. Since January 1993, he has served as Executive Vice President, Chief Real Estate and Store Development Officer and Assistant Secretary. From 1993 to 2001 Mr. Severson also served as a director. From August 1989 through January 1993, Mr. Severson served as Senior Vice President - Chief Real Estate Officer.

Thomas W. Stoltz joined the Company as Executive Vice President, Chief Financial Officer in December 2006. From 2000 through 2006, he was employed by Citi Trends, Inc., a specialty retailer, as Chief Financial Officer. From 1999 to 2000, he was employed by Sharon Luggage and Gifts, a luggage and gift retailer, as Chief Financial Officer. From 1996 through 1998, he was employed by Factory Card Outlet Corp, a card specialty retailer, as Chief Financial Officer. From 1994 to 1996, he was employed by Dollar General Corp, a discount retailer, as Interim Chief Financial Officer and Corporate Controller.

Stuart L. Uselton joined the Company as Vice President, Tax and Treasury in July 2000. Since November 2006, he has served as Executive Vice President, Chief Administrative Officer. From 1991 to 2000, he was employed by Tractor Supply Company, a supply specialty retailer, as Director of Tax and Assistant Treasurer. From 1984 to 1991, he was employed by Deloitte & Touche LLP, as a Tax Manager.

B. Allen Weinstein joined the Company as Executive Vice President, Chief Merchandising Officer of the Cato Division in August 1997 and served in that position until November 2004. Since November 2004, he has served as Executive Vice President, Chief Merchandising Officer of the Company. From 1995 to 1997, he was Senior Vice President Merchandising of Catherines Stores Corporation. From 1981 to 1995, he served as Senior Vice President of Merchandising for Bealls, Inc.

PART II**Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities:****Market & Dividend Information**

The Company's Class A Common Stock trades on the New York Stock Exchange (NYSE) under the symbol CTR. As required by Section 3.03A.12(a) of the NYSE listing standards, The Cato Corporation filed with the NYSE the annual certification of its Chief Executive Officer that he is not aware of any violation by the Company of NYSE corporate governance listing standards. Below is the market range and dividend information for the four quarters of fiscal 2007 and 2006.

| 2007 | Price | | Dividend |
|----------------|--------------|------------|-----------------|
| | High | Low | |
| First quarter | \$ 24.19 | \$ 20.38 | \$.15 |
| Second quarter | 25.01 | 20.54 | .165 |
| Third quarter | 22.07 | 17.86 | .165 |
| Fourth quarter | 19.85 | 13.49 | .165 |

| 2006 | Price | | Dividend |
|----------------|--------------|------------|-----------------|
| | High | Low | |
| First quarter | \$ 23.86 | \$ 19.80 | \$.13 |
| Second quarter | 26.25 | 21.86 | .15 |
| Third quarter | 25.52 | 21.91 | .15 |
| Fourth quarter | 24.94 | 21.70 | .15 |

As of March 25, 2008 the approximate number of record holders of the Company's Class A Common Stock was 3,806 and there were 2 record holders of the Company's Class B Common Stock.

Stock Performance Graph

The following graph compares the yearly change in the Company's cumulative total shareholder return on the Company's Common Stock (which includes Class A Stock and Class B Stock) for each of the Company's last five fiscal years with (i), the Dow Jones U.S. Retailers Apparel Index and (ii) the Russell 2000 Index.

**The Cato Corporation
Stock Performance Graph**

THE CATO CORPORATION
STOCK PERFORMANCE TABLE
(BASE 100 IN DOLLARS)

| LAST TRADING DAY OF THE FISCAL YEAR | THE CATO CORPORATION | DOW JONES U.S. RETAILERS, APPL INDEX | RUSSELL 2000 INDEX |
|--|-------------------------|--|-----------------------|
| 1/31/03 | 100 | 100 | 100 |
| 1/30/04 | 118 | 134 | 158 |
| 1/28/05 | 168 | 162 | 169 |
| 1/27/06 | 182 | 184 | 204 |
| 2/02/07 | 192 | 223 | 228 |
| 2/01/08 | 140 | 176 | 208 |

The graph assumes an initial investment of \$100 on January 31, 2003, the last trading day prior to the commencement of the Company's 2003 fiscal year, and that all dividends were reinvested.

Securities Authorized For Issuance Under Equity Compensation Plans

The following table provides information about stock options outstanding and shares available for future awards under all of Cato's equity compensation plans. The information is as of February 2, 2008.

| Plan Category | (a) Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights | (b) Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights | (c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (excluding securities reflected in column (a)) |
|--|--|--|--|
| Equity compensation plans approved by security holders | 139,075 | \$ 12.41 | 1,272,220 |
| Equity compensation plans not approved by security holders | | | |
| Total | 139,075 | \$ 12.41 | 1,272,220 |

Issuer Purchases of Equity Securities

The following table summarizes the Company's purchases of its common stock for the three months ended February 2, 2008.

| Period | Total Number of Shares Purchased | Average Price Paid per Share(2) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(1) | Maximum Number (or Approximate Dollar Value) of Shares that may Yet be Purchased Under The Plans or Programs(1) |
|---------------|---|--|--|--|
| November 2007 | 691,900 | \$ 18.87 | 691,900 | |
| December 2007 | 1,455,100 | 15.35 | 1,455,100 | |
| January 2008 | 186,600 | 15.33 | 186,600 | |

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| | | | | | |
|-------|-----------|----|-------|-----------|----------------|
| Total | 2,333,600 | \$ | 16.39 | 2,333,600 | 394,660 shares |
|-------|-----------|----|-------|-----------|----------------|

(1) On August 30, 2007, the Company's Board of Directors authorized an increase in the share repurchase program of two million shares. At fiscal year end February 2, 2008, the Company had 394,660 shares remaining in open authorizations. There is no specified expiration date for the Company's repurchase program. In fiscal 2007, the Company repurchased 3.162 million shares under this program for approximately \$54.1 million or an average market price per share of \$17.11. In addition, 205,891 shares at an average market price per share of \$21.70 were tendered as partial payment of the exercise price of an employee stock option and the related tax withholding.

(2) Prices include trading costs.

Item 6. Selected Financial Data:

Certain selected financial data for the five fiscal years ended February 2, 2008 have been derived from the Company's audited financial statements. The financial statements and Independent Registered Public Accounting Firm's reports for the three most recent fiscal years are contained elsewhere in this report. All data set forth below are qualified by reference to, and should be read in conjunction with, the Company's Consolidated Financial Statements (including the Notes thereto) and Management's Discussion and Analysis of Financial Condition and Results of Operations appearing elsewhere in this annual report.

The five-year selected consolidated financial data presented in this Item 6 has been adjusted to reflect a three-for-two stock split in the form of a stock dividend of the Company's Class A and Class B Common Stock effected June 27, 2005.

| Fiscal Year | 2007 | 2006 | 2005 | 2004 | 2003 |
|---|---|------------|------------|------------|------------|
| | (Dollars in thousands, except per share data and selected operating data) | | | | |
| STATEMENT OF OPERATIONS DATA: | | | | | |
| Retail sales | \$ 834,341 | \$ 862,813 | \$ 821,639 | \$ 773,809 | \$ 731,770 |
| Other income | 12,096 | 13,072 | 14,742 | 15,795 | 15,497 |
| Total revenues | 846,437 | 875,885 | 836,381 | 789,604 | 747,267 |
| Cost of goods sold (exclusive of depreciation shown below) | 572,309 | 572,712 | 546,955 | 528,916 | 508,991 |
| Gross margin | 262,032 | 290,101 | 274,684 | 244,893 | 222,779 |
| Gross margin percent | 31.4% | 33.6% | 33.4% | 31.6% | 30.4% |
| Selling, general and administrative | 210,892 | 212,157 | 203,156 | 187,618 | 174,202 |
| Selling, general and administrative percent of retail sales | 25.3% | 24.6% | 24.7% | 24.2% | 23.8% |
| Depreciation | 22,212 | 20,941 | 20,275 | 20,397 | 18,695 |
| Interest expense | 9 | 41 | 183 | 717 | 306 |
| Interest and other income | (8,218) | (9,597) | (4,563) | (2,739) | (3,614) |
| Income before income taxes | 49,233 | 79,631 | 70,375 | 54,695 | 48,687 |
| Income tax expense | 16,914 | 28,181 | 25,546 | 19,854 | 17,673 |
| Net income | \$ 32,319 | \$ 51,450 | \$ 44,829 | \$ 34,841 | \$ 31,014 |
| Basic earnings per share | \$ 1.03 | \$ 1.64 | \$ 1.44 | \$ 1.13 | \$.89 |
| Diluted earnings per share | \$ 1.03 | \$ 1.62 | \$ 1.41 | \$ 1.11 | \$.88 |
| Cash dividends paid per share | \$.645 | \$.58 | \$.507 | \$.457 | \$.42 |
| SELECTED OPERATING DATA: | | | | | |
| Stores open at end of year | 1,318 | 1,276 | 1,244 | 1,177 | 1,102 |
| Average sales per store(1) | \$ 640,000 | \$ 685,000 | \$ 684,000 | \$ 682,000 | \$ 692,000 |
| Average sales per square foot of selling space | \$ 165 | \$ 175 | \$ 173 | \$ 170 | \$ 171 |
| Comparable store sales increase (decrease) | (4)% | (2)% | 1% | 0% | (7)% |

BALANCE SHEET DATA (at period end):

| | | | | | |
|---|-------------------|------------|------------|------------|-----------|
| Cash, cash equivalents and short-term investments | \$ 114,578 | \$ 123,542 | \$ 107,819 | \$ 107,228 | \$ 71,402 |
| Working capital | 144,114 | 176,464 | 139,114 | 136,980 | 117,403 |
| Total assets | 420,792 | 432,322 | 406,636 | 397,323 | 356,284 |
| Total stockholders' equity | 247,370 | 276,793 | 239,948 | 211,175 | 186,075 |

(1) Calculated using actual sales volume for stores open for the full year and an estimated annual sales volume for new stores opened during the year.

(2) The fiscal year 2006 contained 53 weeks versus 52 weeks for all other years shown.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations:**Results of Operations**

The table below sets forth certain financial data of the Company expressed as a percentage of retail sales for the years indicated:

| Fiscal Year Ended | February 2, 2008 | February 3, 2007 | January 28, 2006 |
|-------------------------------------|-----------------------------|-----------------------------|-----------------------------|
| Retail sales | 100.0% | 100.0% | 100.0% |
| Other income | 1.4 | 1.5 | 1.8 |
| Total revenues | 101.4 | 101.5 | 101.8 |
| Cost of goods sold | 68.6 | 66.4 | 66.6 |
| Selling, general and administrative | 25.3 | 24.6 | 24.7 |
| Depreciation | 2.7 | 2.4 | 2.5 |
| Interest and other income | (1.0) | (1.1) | (0.6) |
| Income before income taxes | 5.9 | 9.2 | 8.6 |
| Net income | 3.9% | 6.0% | 5.5% |

Fiscal 2007 Compared to Fiscal 2006

Retail sales decreased by 3.3% to \$834.3 million in fiscal 2007 compared to \$862.8 million in fiscal 2006. The fiscal year ended February 2, 2008 contained 52 weeks versus 53 weeks in fiscal year ended February 3, 2007. The decrease in retail sales in fiscal 2007 was attributable to the reduction of one week of sales estimated at \$18.7 million and the difficult retail environment. On an equivalent 52 week basis, comparable store sales decreased 4% from fiscal 2006. Total revenues, comprised of retail sales and other income (principally finance charges and late fees on customer accounts receivable and layaway fees), decreased by 3.4% to \$846.4 million in fiscal 2007 compared to \$875.9 million in fiscal 2006. The Company operated 1,318 stores at February 2, 2008 compared to 1,276 stores operated at February 3, 2007.

In fiscal 2007, the Company opened 62 new stores, relocated 18 stores, remodeled 9 stores and closed 20 stores.

Other income in total, as included in total revenues in fiscal 2007, decreased slightly to \$12.1 million from \$13.1 million in fiscal 2006. The decrease resulted primarily from credit revenue and finance and layaway charges.

Credit revenue of \$10.4 million represented 1.2% of total revenue in fiscal 2007. This is comparable to 2006 credit revenue of \$10.9 million or 1.2% of total revenue. The decrease in credit revenue was primarily due to reductions in finance charge income as a result of lower accounts receivable balances. 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 \$6.1 million in fiscal 2007 compared to \$5.9 million in fiscal 2006. The increase in these expenses was principally due to higher bad debt expense in fiscal 2007. See Note 14 of the Consolidated Financial Statements for a schedule of credit related expenses. Total segment credit income before taxes decreased \$0.6 million from \$4.9 million in 2006 to \$4.3 million in 2007 due to decreased finance charge income and increased bad debt expense. Total credit income of \$4.3 million in 2007 represented 8.7% of total income before taxes of \$49.2 million compared to total credit income of \$4.9 million in 2006 which represented 6.1% of 2006 total income before taxes.

Cost of goods sold was \$572.3 million, or 68.6% of retail sales, in fiscal 2007 compared to \$572.7 million, or 66.4% of retail sales, in fiscal 2006. The increase in cost of goods sold as a percent of retail sales resulted primarily from higher occupancy costs and higher markdowns. 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) decreased by 9.7% to

\$262.0 million in fiscal 2007 from \$290.1 million in fiscal 2006. Gross margin as presented may not be comparable to that of other companies.

Selling, general and administrative expenses (SG&A), which primarily include corporate and store payroll, related payroll taxes and benefits, insurance, supplies, advertising, bank and credit card processing fees and bad debts were \$210.9 million in fiscal 2007 compared to \$212.2 million in fiscal 2006, a decrease of 0.6%. As a percent of retail sales, SG&A was 25.3% compared to 24.6% in the prior year. The overall dollar decrease in SG&A resulted primarily from a decrease in incentive based compensation expenses offset by increased salary expense driven by store development and increased health care expenses.

Depreciation expense was \$22.2 million in fiscal 2007 compared to \$20.9 million in fiscal 2006. The depreciation expense in fiscal 2007 and 2006 resulted primarily from the Company's store development activity and investment in technology.

Interest and other income was \$8.2 million in fiscal 2007 compared to \$9.6 million in fiscal 2006. The decrease is due to the settlement of a \$2.4 million insurance claim for hurricane losses received in the fourth quarter of fiscal 2006, partially offset by higher interest income due to increased rates and higher average invested balances. See Note 2 to the Consolidated Financial Statements for details.

Income tax expense was \$16.9 million, or 2.0% of retail sales in fiscal 2007 compared to \$28.2, or 3.2% of retail sales in fiscal 2006. The decrease resulted from lower pre-tax income in conjunction with a reduction in the effective tax rate. The effective tax rate was 34.4% in fiscal 2007 and 35.4% in fiscal 2006. The Company expects the effective rate in 2008 to be approximately 34.0% to 36.0%.

Fiscal 2006 Compared to Fiscal 2005

Retail sales increased by 5% to \$862.8 million in fiscal 2006 compared to \$821.6 million in fiscal 2005. The fiscal year ended February 3, 2007 contained 53 weeks versus 52 weeks in fiscal year ended January 28, 2006. The increase in retail sales in fiscal 2006 was attributable to sales from new stores and the additional week. The additional week in fiscal 2006 increased total sales by \$17.2 million for the year. On an equivalent 53 week basis, comparable store sales decreased 2% from the prior year. Total revenues, comprised of retail sales and other income (principally finance charges and late fees on customer accounts receivable and layaway fees), increased by 5% to \$875.9 million in fiscal 2006 compared to \$836.4 million in fiscal 2005. The Company operated 1,276 stores at February 3, 2007 compared to 1,244 stores operated at January 28, 2006.

In fiscal 2006, the Company opened 58 new stores, relocated 20 stores, remodeled 8 stores and closed 26 stores.

Credit revenue of \$10.9 million represented 1.2% of total revenue in fiscal 2006. This is comparable to 2005 credit revenue of \$12.7 million or 1.5% of total revenue. The decrease in credit revenue was primarily due to reductions in finance charge and late fee income as a result of lower accounts receivable balances and a higher percentage of accounts current. 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 \$5.9 million in fiscal 2006 compared to \$7.9 million in fiscal 2005. The decrease in these expenses was principally due to lower bad debt expense in fiscal 2006. See Note 14 of the Consolidated Financial Statements for a schedule of credit related expenses. Total credit income before taxes increased \$0.2 million from \$4.7 million in 2005 to \$4.9 million in 2006 due to decreased bad debt expense. Total credit income of \$4.9 million in 2006 represented 6.2% of total income before taxes of \$79.6 million.

Other income in total, as included in total revenues in fiscal 2006, decreased slightly to \$13.1 million from \$14.7 million in fiscal 2005. The decrease resulted primarily from a decrease in finance and late charges.

Cost of goods sold was \$572.7 million, or 66.4% of retail sales, in fiscal 2006 compared to \$547.0 million, or 66.6% of retail sales, in fiscal 2005. The decrease in cost of goods sold as a percent of retail sales resulted primarily from lower procurement costs and reduced markdowns. The reduction in procurement costs is primarily the result of increased direct sourcing and the reduction in markdowns is primarily due to improved inventory control and increased sales 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) increased by 6% to \$290.1 million in fiscal 2006 from \$274.7 million in fiscal 2005. Gross margin as presented may not be comparable to those of other companies.

Selling, general and administrative expenses (SG&A), which primarily include corporate and store payroll, related payroll taxes and benefits, insurance, supplies, advertising, bank and credit card processing fees and bad debts were \$212.2 million in fiscal 2006 compared to \$203.2 million in fiscal 2005, an increase of 4%. As a percent of retail sales, SG&A was 24.6% compared to 24.7% in the prior year. The overall dollar increase in SG&A resulted primarily from increased salary expense driven by store development, offset by a decrease in incentive based compensation expenses.

Depreciation expense was \$20.9 million in fiscal 2006 compared to \$20.3 million in fiscal 2005. The depreciation expense in fiscal 2006 and 2005 resulted primarily from the Company's store development activity and investment in technology.

Interest and other income was \$9.6 million in fiscal 2006 compared to \$4.6 million in fiscal 2005. The increase in fiscal 2006 resulted primarily from higher interest rates, settlement of insurance claims for losses attributable to hurricanes during the third quarter of fiscal 2005 of \$2.4 million received in the fourth quarter of fiscal 2006, and a refund settlement on third-party credit card fees of \$0.5 million received in the second quarter of fiscal 2006.

Income tax expense was \$28.2 million, or 3.2% of retail sales in fiscal 2006 compared to \$25.5 million, or 3.1% of retail sales in fiscal 2005. The increase resulted from higher pre-tax income, partially offset by a reduction in the effective tax rate. The effective tax rate was 35.4% in fiscal 2006 and 36.3% in fiscal 2005.

Off Balance Sheet Arrangements

Other than operating leases in the ordinary course of business, the Company is not a party to any off-balance sheet arrangements that have, or are reasonably likely to have, a current or future material effect on the Company's financial condition, revenues, expenses, results of operations, liquidity, capital expenditures or capital resources.

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 judgement. 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.

Allowance for Doubtful Accounts

The Company evaluates the collectibility of accounts receivable and records an allowance for doubtful accounts based on estimates of actual write-offs and the accounts receivable aging roll rates over a period of up to 12 months. The allowance is reviewed for adequacy and adjusted, as necessary, on a quarterly basis. The Company also provides for estimated uncollectible late fees charged based on historical write-offs. The Company's financial results can be significantly impacted by changes in bad debt write-off experience and the aging of the accounts receivable portfolio.

Merchandise Inventories

The Company's inventory is valued using the retail method of accounting and is stated at the lower of cost (first-in, first-out method) or market. Under the retail inventory method, the valuation of inventory at cost and resulting gross margin are calculated by applying an average cost to retail ratio to the retail value of inventory. The retail inventory method is an averaging method that has been widely used in the retail industry. Inherent in the retail method are certain significant estimates, including initial merchandise markup, markdowns and shrinkage, which significantly impact the ending inventory valuation at cost and the resulting gross margins. Physical inventories are conducted throughout the year to calculate actual shrinkage and inventory on hand. Estimates based on actual shrinkage results are used to estimate inventory shrinkage, which is accrued for the period between the last inventory and the financial reporting date. The Company continuously reviews its inventory levels to identify slow moving merchandise and uses markdowns to clear slow moving inventory. The general economic environment for retail apparel sales could result in an increase in the level of markdowns, which would result in lower inventory values and increases to cost of goods sold as a percentage of net sales in future periods. Management makes estimates regarding markdowns based on inventory levels on hand and customer demand, which may impact inventory valuations. Markdown exposure with respect to inventories on hand is limited due to the fact that seasonal merchandise is not carried forward. Historically, actual results have not significantly deviated from those determined using the estimates described above.

Lease Accounting

The Company recognizes rent expense on a straight-line basis over the lease term as defined in SFAS No. 13, *Accounting for Leases*. Our lease agreements generally provide for scheduled rent increases during the lease term or rent holidays, including rental payments commencing at a date other than the date of initial occupancy. We include any rent escalation and rent holidays in our straight-line rent expense. In addition, we record landlord allowances for normal tenant improvements as deferred rent, which is included in other noncurrent liabilities in the consolidated balance sheets. This deferred rent is amortized over the lease term as a reduction of rent expense. Also, leasehold improvements are amortized using the straight-line method over the shorter of their estimated useful lives or the related lease term. See Note 1 to the Consolidated Financial Statements for further information on the Company's accounting for its leases.

Impairment of Long-Lived Assets

The Company primarily invests in property and equipment in connection with the opening and remodeling of stores and in computer software and hardware. The Company periodically reviews its store locations and estimates the recoverability of its assets, recording an impairment charge, if necessary, when the Company decides to close the store or otherwise determines that future undiscounted cash flows associated with those assets will not be sufficient to recover the carrying value. This determination is based on a number of factors, including the store's historical operating results and cash flows, estimated future sales growth, real estate development in the area and perceived local market conditions that can be difficult to predict and may be subject to change. In addition, the Company regularly evaluates its computer-related and other long-lived assets and may accelerate depreciation over the revised useful life if the asset is expected to be replaced or has limited future value. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation or amortization are removed from the accounts, and any resulting gain or loss is reflected in income for that period.

Insurance Liabilities

The Company is primarily self-insured for health care, workers' compensation and general liability costs. These costs are significant primarily due to the large number of the Company's retail locations and associates. The Company's self-insurance liabilities are based on the total estimated costs of claims filed and estimates of claims incurred but not

reported, less amounts paid against such claims, and are not discounted. Management reviews current and historical claims data in developing its estimates. The Company also uses information provided by outside actuaries with respect to workers' compensation and general liability claims. If the underlying facts and circumstances of the claims change or the historical experience upon which insurance provisions are recorded is not indicative of future trends, then the Company may be required to make adjustments to the provision for insurance.

costs that could be material to the Company's reported financial condition and results of operations. Historically, actual results have not significantly deviated from estimates.

Uncertain Tax Positions

The Company records liabilities for uncertain tax positions principally related to state income taxes as of the balance sheet date. These liabilities reflect the Company's best estimate of its ultimate income tax liability based on the tax codes, regulations, and pronouncements of the jurisdictions in which we do business. Estimating our ultimate tax liability involves significant judgments regarding the application of complex tax regulations across many jurisdictions. Despite our belief that our estimates and judgments are reasonable, differences between our estimated and actual tax liabilities could exist. These differences may arise from settlements of tax audits, expiration of the statute of limitations, or the evolution and application of the various jurisdictional tax codes and regulations. Any differences will be recorded in the period in which they become known and could have a material effect on the results of operations in the period the adjustment is recorded.

Revenue Recognition

While the Company's recognition of revenue is predominantly derived from routine retail transactions and does not involve significant judgment, revenue recognition represents an important accounting policy of the Company. As discussed in Note 1 to the Consolidated Financial Statements, the Company recognizes sales at the point of purchase when the customer takes possession of the merchandise and pays for the purchase, generally with cash or credit. Sales from purchases made with Cato credit, gift cards and layaway sales are also recorded when the customer takes possession of the merchandise. Gift cards, layaway deposits and merchandise credits granted to customers are recorded as deferred revenue until they are redeemed or forfeited. Gift cards and merchandise credits do not have expiration dates. A provision is made for estimated product returns based on sales volumes and the Company's experience; actual returns have not varied materially from amounts provided historically.

Beginning with the fourth quarter of fiscal 2007, the Company began recognizing income on unredeemed gift cards (gift card breakage) as a component of other income. Gift card breakage is determined after 60 months when the likelihood of the remaining balances being redeemed is remote based on our historical redemption data and there is no legal obligation to remit the remaining balances to relevant jurisdictions. Gift card breakage income will be recognized on a quarterly basis and is not expected to be material.

Credit revenue on the Company's private label credit card portfolio is recognized as earned under the interest method. Late fees are recognized as earned, less provisions for estimated uncollectible fees.

Liquidity, Capital Resources and Market Risk

The Company has consistently maintained a strong liquidity position. Cash provided by operating activities during fiscal 2007 was \$74.2 million as compared to \$58.7 million in fiscal 2006. These amounts have enabled the Company to fund its regular operating needs, capital expenditure program, cash dividend payments and any repurchase of the Company's common stock. In addition, the Company maintains \$35.0 million of unsecured revolving credit facilities for short-term financing of seasonal cash needs, none of which was outstanding at February 2, 2008.

Cash provided by operating activities for these periods was primarily generated by earnings adjusted for depreciation, deferred taxes, and changes in working capital. The increase of \$15.5 million for fiscal 2007 over fiscal 2006 is primarily due to an increase in accounts payable due to more favorable terms with certain merchandise vendors, offset by a decrease in accrued bonus and benefits and deferred income taxes combined with the decrease in net earnings of \$19.1 million.

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 proposed capital expenditures, dividends, purchase of treasury stock and other operating requirements for fiscal 2008 and for the foreseeable future.

At February 2, 2008, the Company had working capital of \$144.1 million compared to \$176.5 million at February 3, 2007. Additionally, the Company had \$2.6 million invested in privately managed investment funds and other miscellaneous equities, which are reported under other noncurrent assets of the consolidated balance sheets.

At February 2, 2008, the Company had an unsecured revolving credit agreement, which provided for borrowings of up to \$35.0 million. The revolving credit agreement was amended October 29, 2007 and has been extended from August 2008 to 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 February 2, 2008. There were no borrowings outstanding under these credit facilities during the fiscal year ended February 2, 2008 or the fiscal year ended February 3, 2007.

On August 22, 2003, the Company entered into a new unsecured \$30.0 million five-year term loan facility, the proceeds of which were used to purchase Class B Common Stock from the Company's founders. Payments were due in monthly installments of \$500,000 plus accrued interest based on LIBOR. On April 5, 2005, the Company repaid the remaining balance of \$20.5 million on this loan facility with no early prepayment penalty. With the early retirement of this loan, the Company had no outstanding debt as of February 2, 2008 or February 3, 2007.

The Company had approximately \$4.3 million and \$4.5 million at February 2, 2008 and February 3, 2007, respectively, of outstanding irrevocable letters of credit relating to purchase commitments.

Expenditures for property and equipment totaled \$18.3 million, \$27.5 million and \$28.5 million in fiscal 2007, 2006 and 2005, respectively. The expenditures for fiscal 2007 were primarily for store development, store remodels and investments in new technology. In fiscal 2008, the Company is planning to invest approximately \$18.9 million in capital expenditures. This includes expenditures to open 75 new stores, relocate 15 stores and close up to 32 stores. In addition, the Company plans to remodel 15 stores and has planned for additional investments in technology scheduled to be implemented over the next 12 months.

Net cash used in investing activities totaled \$12.1 million for fiscal 2007 compared to \$40.0 million used for the comparable period of 2006. The decrease was due primarily to a reduction in expenditures for property and equipment offset by the net reduction in sale 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.

The Company does not use derivative financial instruments. At February 2, 2008, the Company's investment portfolio was primarily invested in auction rate securities and governmental securities held in a managed fund. These securities are classified as available-for-sale as they are highly liquid 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 Consolidated Balance Sheets.

As of February 2, 2008, the Company held \$41.9 million in auction rate securities (ARS) backed by tax exempt municipal debt rated A or better. The underlying securities have contractual maturities which generally range from seven to thirty years and are classified as available for sale and recorded at fair value due to the resetting of the interest rates every 7 to 35 days. Of the \$41.9 million in ARS, \$13.9 million failed their last auction subsequent to February 2, 2008. As a result, our ability to liquidate these investments in the near term may be limited. The Company believes it has sufficient liquidity for its current needs without selling any failed ARS and does not currently intend to liquidate these securities until market conditions improve. The underlying securities of the failed auctions remain sound and the Company does not expect any losses or impairment. To date, the Company has collected all interest payments on all

of its ARS when due and expects to continue to do so in the future.

The following table shows the Company's obligations and commitments as of February 2, 2008, to make future payments under noncancellable contractual obligations (in thousands):

| Contractual Obligations | Total | Payments Due During One Year Fiscal Period Ending | | | | | Thereafter |
|-------------------------------|------------|---|-----------|-----------|-----------|-------|------------|
| | | 2008 | 2009 | 2010 | 2011 | 2012 | |
| Uncertain tax positions(1) | \$ 9,180 | \$ | \$ | \$ | \$ | \$ | \$ 9,180 |
| Merchandise letters of credit | 4,274 | 4,274 | | | | | |
| Operating leases | 153,046 | 54,095 | 40,312 | 29,501 | 19,356 | 9,614 | 168 |
| Total Contractual Obligations | \$ 166,500 | \$ 58,369 | \$ 40,312 | \$ 29,501 | \$ 19,356 | 9,614 | \$ 9,348 |

(1) Due to the nature of this obligation, the Company is unable to estimate the timing of the cash outflows.

Recent Accounting Pronouncements

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 included: 1) 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; and 2) quarterly amortization related to all stock option awards granted subsequent to January 29, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. The impact on the Company's consolidated financial statements for fiscal 2006 was an additional compensation expense of \$235,000.

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 Standards Accounting Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109*, on February 4, 2007. See Note 12 to Consolidated Financial Statements, Income Taxes.

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 consolidated financial statements.

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. The provisions of SFAS 159 are effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact, if any, that the adoption of SFAS 159 will have on the Company's consolidated financial statements.

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 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 No. 06-11 is effective for fiscal years beginning on or after December 15, 2007. We are currently evaluating the impact that this standard may have on our results of operations and financial position.

Item 7A. *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.

Item 8. *Financial Statements and Supplementary Data:*

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of
The Cato Corporation:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of The Cato Corporation and its subsidiaries at February 2, 2008 and February 3, 2007, and the results of their operations and their cash flows for each of the three years in the period ended February 2, 2008 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of February 2, 2008, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control over Financial Reporting located under Item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Charlotte, NC
April 1, 2008

THE CATO CORPORATION
CONSOLIDATED STATEMENTS OF INCOME AND
COMPREHENSIVE INCOME

| | Fiscal Year Ended | | |
|--|--|-----------------------------|-----------------------------|
| | February 2, 2008 | February 3, 2007 | January 28, 2006 |
| | (Dollars in thousands, except per share data) | | |
| REVENUES | | | |
| Retail sales | \$ 834,341 | \$ 862,813 | \$ 821,639 |
| Other income (principally finance charges, late fees and layaway charges) | 12,096 | 13,072 | 14,742 |
| Total revenues | 846,437 | 875,885 | 836,381 |
| COSTS AND EXPENSES, NET | | | |
| Cost of goods sold (exclusive of depreciation shown below) | 572,309 | 572,712 | 546,955 |
| Selling, general and administrative | 210,892 | 212,157 | 203,156 |
| Depreciation | 22,212 | 20,941 | 20,275 |
| Interest expense | 9 | 41 | 183 |
| Interest and other income | (8,218) | (9,597) | (4,563) |
| | 797,204 | 796,254 | 766,006 |
| Income before income taxes | 49,233 | 79,631 | 70,375 |
| Income tax expense | 16,914 | 28,181 | 25,546 |
| Net income | \$ 32,319 | \$ 51,450 | \$ 44,829 |
| Basic earnings per share | \$ 1.03 | \$ 1.64 | \$ 1.44 |
| Basic weighted average shares | 31,279,918 | 31,281,163 | 31,117,214 |
| Diluted earnings per share | \$ 1.03 | \$ 1.62 | \$ 1.41 |
| Diluted weighted average shares | 31,513,202 | 31,815,332 | 31,789,887 |
| Dividends per share | \$.645 | \$.580 | \$.507 |
| Comprehensive income: | | | |
| Net income | \$ 32,319 | \$ 51,450 | \$ 44,829 |
| Unrealized gains on available-for-sale securities, net of deferred income tax liability or benefit | 484 | 147 | 7 |

| | | | | | | |
|--------------------------|----|---------------|----|--------|----|--------|
| Net comprehensive income | \$ | 32,803 | \$ | 51,597 | \$ | 44,836 |
|--------------------------|----|---------------|----|--------|----|--------|

See notes to consolidated financial statements.

THE CATO CORPORATION
CONSOLIDATED BALANCE SHEETS

| | February 2, 2008 | February 3, 2007 |
|--|------------------------|---------------------|
| | (Dollars in thousands) | |
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 21,583 | \$ 24,833 |
| Short-term investments | 92,995 | 98,709 |
| Accounts receivable, net of allowance for doubtful accounts of \$3,263 at February 2, 2008 and \$3,554 at February 3, 2007 | 45,282 | 45,958 |
| Merchandise inventories | 118,679 | 115,918 |
| Deferred income taxes | 6,756 | 7,508 |
| Prepaid expenses | 7,755 | 6,587 |
| Total Current Assets | 293,050 | 299,513 |
| Property and equipment net | 123,190 | 128,461 |
| Other assets | 4,552 | 4,348 |
| Total Assets | \$ 420,792 | \$ 432,322 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current Liabilities: | | |
| Accounts payable | \$ 110,848 | \$ 77,046 |
| Accrued expenses | 27,617 | 29,526 |
| Accrued bonus and benefits | 2,543 | 10,756 |
| Accrued income taxes | 7,928 | 5,721 |
| Total Current Liabilities | 148,936 | 123,049 |
| Deferred income taxes | 1,707 | 8,817 |
| Other noncurrent liabilities (primarily deferred rent) | 22,779 | 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; 36,109,263 and 35,955,815 shares issued at February 2, 2008 and February 3, 2007, respectively | 1,204 | 1,199 |
| Convertible Class B common stock, \$.033 par value per share, 15,000,000 shares authorized; issued 1,743,525 and 690,525 shares at February 2, 2008 and February 3, 2007, respectively | 58 | 23 |
| Additional paid-in capital | 58,685 | 42,475 |
| Retained earnings | 340,088 | 327,684 |

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| | | |
|--|-------------------|------------|
| Accumulated other comprehensive income | 709 | 225 |
| | 400,744 | 371,606 |
| Less Class A common stock in treasury, at cost (8,461,615 shares at February 2, 2008 and 5,093,609 shares at February 3, 2007, respectively) | (153,374) | (94,813) |
| Total Stockholders' Equity | 247,370 | 276,793 |
| Total Liabilities and Stockholders' Equity | \$ 420,792 | \$ 432,322 |

See notes to consolidated financial statements.

THE CATO CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Fiscal Year Ended | | |
|---|-------------------------------|-----------------------------|-----------------------------|
| | February 2, 2008 | February 3, 2007 | January 28, 2006 |
| | (Dollars in thousands) | | |
| OPERATING ACTIVITIES | | | |
| Net income | \$ 32,319 | \$ 51,450 | \$ 44,829 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation | 22,212 | 20,941 | 20,275 |
| Provision for doubtful accounts | 2,844 | 2,633 | 4,650 |
| Share based compensation | 1,694 | 1,326 | 682 |
| Excess tax benefits from share-based compensation | (5,964) | (768) | |
| Deferred income taxes | (6,358) | 574 | (3,656) |
| Loss on disposal of property and equipment | 1,163 | 2,079 | 1,757 |
| Changes in operating assets and liabilities which provided (used) cash: | | | |
| Accounts receivable | (2,168) | 1,053 | (3,405) |
| Merchandise inventories | (2,761) | (12,548) | (2,832) |
| Prepaid and other assets | (1,372) | 2,238 | (1,065) |
| Accrued income taxes | 8,533 | 1,499 | 525 |
| Accounts payable, accrued expenses and other liabilities | 24,022 | (11,776) | 9,183 |
| Net cash provided by operating activities | 74,164 | 58,701 | 70,943 |
| INVESTING ACTIVITIES | | | |
| Expenditures for property and equipment | (18,330) | (27,547) | (28,512) |
| Purchases of short-term investments | (313,761) | (180,463) | (94,845) |
| Sales of short-term investments | 319,960 | 167,985 | 97,355 |
| Net cash used in investing activities | (12,131) | (40,025) | (26,002) |
| FINANCING ACTIVITIES | | | |
| Change in cash overdrafts included in accounts payable | (1,000) | 500 | (3,100) |
| Dividends paid | (20,277) | (18,228) | (15,867) |
| Purchases of treasury stock | (58,561) | | (3,536) |
| Payments to settle long term debt | | | (22,000) |
| Proceeds from employee stock purchase plan | 481 | 413 | 430 |
| Excess tax benefits from share-based compensation | 5,964 | 768 | |
| Proceeds from stock options exercised | 8,110 | 970 | 2,226 |
| Net cash used in financing activities | (65,283) | (15,577) | (41,847) |

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| | | | |
|--|------------------|-----------|-----------|
| Net increase (decrease) in cash and cash equivalents | (3,250) | 3,099 | 3,094 |
| Cash and cash equivalents at beginning of year | 24,833 | 21,734 | 18,640 |
| Cash and cash equivalents at end of year | \$ 21,583 | \$ 24,833 | \$ 21,734 |

See notes to consolidated financial statements.

THE CATO CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

| | Convertible | | Additional Paid-in Capital | Accumulated | | | Treasury Stock | Total Stockholders Equity |
|--|----------------------------|----------------------------|----------------------------------|--|----------------------------------|---|-------------------|---------------------------------|
| | Class A Common Stock | Class B Common Stock | | Retained Earnings (Dollars in thousands) | Other Comprehensive Income | Unearned Compensation Restricted Stock Awards | | |
| Balance January 29, 2005 | 875 | 187 | 103,366 | 265,499 | 71 | (911) | (157,912) | 211,175 |
| Comprehensive income: | | | | | | | | |
| Net income | | | | 44,829 | | | | 44,829 |
| Unrealized gains on available-for-sale securities, net of deferred income tax liability of \$3 | | | | | 7 | | | 7 |
| Dividends paid (\$.507 per share) | | | | (15,866) | | | | (15,866) |
| Class A common stock sold through employee stock purchase plan 28,684 shares | 1 | | 429 | | | | | 430 |
| Class A common stock sold through stock option plans 172,025 shares | 5 | | 1,310 | | | | | 1,315 |
| Income tax benefit from stock options exercised | | | 912 | | | | | 912 |
| Purchase of treasury shares 186,531 | | | | | | | (3,536) | (3,536) |
| Cancellation of treasury shares 6,136,354 | 143 | | (66,773) | | | | 66,630 | |
| Shares reclassified from Class B to Class A 4,907,309 shares | 164 | (164) | | | | | | |
| Unearned compensation restricted stock awards | | | | | | 682 | | 682 |
| Balance January 28, 2006 | 1,188 | 23 | 39,244 | 294,462 | 78 | (229) | (94,818) | 239,948 |
| Comprehensive income: | | | | | | | | |
| Net income | | | | 51,450 | | | | 51,450 |
| Unrealized gains on available-for-sale | | | | | 147 | | | 147 |

| | | | | | | | | |
|--|-------|----|--------|---------|----------|-----|----------|----------|
| securities, net of deferred income tax liability of \$78 | | | | | | | | |
| Dividends paid (\$.58 per share) | | | | | (18,228) | | | (18,228) |
| Class A common stock sold through employee stock purchase plan | | | | | | | | |
| 22,873 shares | 1 | | 484 | | | | | 485 |
| Class A common stock sold through stock option plans | | | | | | | | |
| 95,775 shares | 3 | | 1,127 | | | | | 1,130 |
| Class A common stock issued through restricted stock grant plans | | | | | | | | |
| 214,882 shares | 7 | | 857 | | | | | 864 |
| Income tax benefit from stock options exercised | | | | | 768 | | | 768 |
| Cancellation of treasury shares 231 shares | | | | | (5) | | 5 | |
| Unearned compensation restricted stock awards | | | | | | 229 | | 229 |
| Balance February 3, 2007 | 1,199 | 23 | 42,475 | 327,684 | 225 | | (94,813) | 276,793 |
| Comprehensive income: | | | | | | | | |
| Net income | | | | 32,319 | | | | 32,319 |
| Unrealized gains on available-for-sale securities, net of deferred income tax liability of \$247 | | | | | 484 | | | 484 |
| Dividends paid (\$.645 per share) | | | | | (20,277) | | | (20,277) |
| Class A common stock sold through employee stock purchase plan | | | | | | | | |
| 27,164 shares | 1 | | 565 | | | | | 566 |
| Class A common stock sold through stock option plans | | | | | | | | |
| 39,200 shares | 1 | | 514 | | | | | 515 |
| Class B common stock sold through stock option plans | | | | | | | | |
| 1,053,000 shares | | 35 | 7,677 | | | | | 7,712 |
| Class A common stock issued through restricted stock grant plans | 3 | | 1,490 | | | | | 1,493 |

| | | | | | | | | |
|--|-------|----|--------|---------|-----|-----------|--|----------|
| 87,085 shares | | | | | | | | |
| Income tax benefit from stock options exercised | | | 5,964 | | | | | 5,964 |
| Repurchase of treasury shares 3,368,006 shares | | | | | | (58,561) | | (58,561) |
| Adoption of FIN 48 | | | | 362 | | | | 362 |
| Balance February 2, 2008 | 1,204 | 58 | 58,685 | 340,088 | 709 | (153,374) | | 247,370 |

See notes to consolidated financial statements.

THE CATO CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies:

Principles of Consolidation: The consolidated financial statements include the accounts of The Cato Corporation and its wholly-owned subsidiaries (the Company). All significant intercompany accounts and transactions have been eliminated.

Description of Business and Fiscal Year: The Company has two business segments—the operation of women's fashion specialty stores and a credit card division. The apparel specialty stores operate under the names Cato, Cato Fashions, Cato Plus, It's Fashion and It's Fashion Metro and are located primarily in strip shopping centers principally in the southeastern United States. The Company's fiscal year ends on the Saturday nearest January 31. Fiscal 2007 had 52 weeks while fiscal 2006 had 53 weeks and fiscal 2005 had 52 weeks.

Use of Estimates: The preparation of the Company's financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant accounting estimates reflected in the Company's financial statements include the allowance for doubtful accounts receivable, reserves relating to self-insured health insurance, workers' compensation liabilities, general and auto insurance liabilities, reserves for inventory markdowns, calculation of asset impairment, inventory shrinkage accrual and tax positions.

Cash and Cash Equivalents and Short-Term Investments: 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.

The Company's short-term investments are all classified as available-for-sale. As they are available for current operations, they are classified in 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 Consolidated Balance Sheets and a reduction of interest and other income in the accompanying Statements of Consolidated 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.

Concentration of Credit Risk: Financial instruments that potentially subject the Company to a concentration of credit risk principally consist of cash equivalents and accounts receivable. The Company places its cash equivalents with high credit qualified institutions and, by practice, limits the amount of credit exposure to any one institution. Concentrations of credit risks with respect to accounts receivable are limited due to the dispersion across different geographies of the Company's customer base.

Supplemental Cash Flow Information: Income tax payments, net of refunds received, for the fiscal years ended February 2, 2008, February 3, 2007 and January 28, 2006 were \$15,012,000, \$26,651,000 and \$28,415,000, respectively. Cash paid for interest for the fiscal years ended February 2, 2008, February 3, 2007 and January 28, 2006 were \$8,000, \$0- and \$143,000, respectively.

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

THE CATO CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Property and Equipment: Property and equipment are recorded at cost. Maintenance and repairs are charged to operations as incurred; renewals and betterments are capitalized. The Company accounts for its software development costs in accordance with the American Institute of Certified Public Accountants Statement of Position (SOP) 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Depreciation is provided on the straight-line method over the estimated useful lives of the related assets excluding leasehold improvements. Leasehold improvements are amortized over the shorter of the estimated useful life or lease term. For leases with renewal periods at the Company's option, the Company generally uses the original lease term plus reasonably assured renewal option periods (generally one five year option period) to determine estimated useful lives. Typical estimated useful lives are as follows:

| Classification | Estimated Useful Lives |
|---|-------------------------------|
| Land improvements | 10 years |
| Buildings | 30-40 years |
| Leasehold improvements | 5-10 years |
| Fixtures and equipment | 3-10 years |
| Information Technology equipment and software | 3-10 years |

Impairment of Long-Lived Assets

The Company primarily invests in property and equipment in connection with the opening and remodeling of stores and in computer software and hardware. The Company periodically reviews its store locations and estimates the recoverability of its assets, recording an impairment charge, if necessary, when the Company decides to close the store or otherwise determines that future undiscounted cash flows associated with those assets will not be sufficient to recover the carrying value. This determination is based on a number of factors, including the store's historical operating results and cash flows, estimated future sales growth, real estate development in the area and perceived local market conditions that can be difficult to predict and may be subject to change. Store asset impairment charges incurred in fiscal 2007, 2006 and 2005 were \$1,039,120, \$479,178 and \$387,139, respectively. In addition, the Company regularly evaluates its computer-related and other long-lived assets and may accelerate depreciation over the revised useful life if the asset is expected to be replaced or has limited future value. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation or amortization are removed from the accounts, and any resulting gain or loss is reflected in income for that period.

Leases

The Company determines the classification of leases consistent with FASB issued Statement No. 13 (SFAS 13). *Accounting for Leases*. The Company leases all of its retail stores. Most lease agreements contain construction allowances and rent escalations. For purposes of recognizing incentives and minimum rental expenses on a straight-line basis over the terms of the leases including renewal periods considered reasonably assured, the Company uses the date of initial possession to begin amortization which is when the Company enters the space and begins to make improvements in preparation for intended use.

For construction allowances, the Company records a deferred rent liability in Other noncurrent liabilities on the consolidated balance sheets and amortizes the deferred rent over the term of the respective lease as reduction to Cost of goods sold on the consolidated statements of income.

For scheduled rent escalation clauses during the lease terms or for rental payments commencing at a date other than the date of initial occupancy, the Company records minimum rental expenses on a straight-line basis over the terms of the leases as defined by SFAS 13.

THE CATO CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Revenue Recognition

The Company recognizes sales at the point of purchase when the customer takes possession of the merchandise and pays for the purchase, generally with cash or credit. Sales from purchases made with Cato credit, gift cards and layaway sales are also recorded when the customer takes possession of the merchandise. Gift cards, layaway deposits and merchandise credits granted to customers are recorded as deferred revenue until they are redeemed or forfeited. Gift cards and merchandise credits do not have expiration dates. A provision is made for estimated product returns based on sales volumes and the Company's experience; actual returns have not varied materially from amounts provided historically.

In the fourth quarter of fiscal 2007, the Company recognized \$79,000 of income on unredeemed gift cards (gift card breakage) as a component of other income. Beginning in fiscal 2007, gift card breakage is determined after 60 months when the likelihood of the remaining balances being redeemed is remote based on our historical redemption data and there is no legal obligation to remit the remaining balances to relevant jurisdictions.

Credit revenue on the Company's private label credit card portfolio is recognized as earned under the interest method. Late fees are recognized as earned, less provisions for estimated uncollectible fees.

Cost of Goods Sold: 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 our buying departments and distribution center. Occupancy expenses include rent, real estate taxes, insurance, common area maintenance, utilities and maintenance for stores and distribution facilities. Buying, distribution, occupancy and internal transfer costs are treated as period costs and are not capitalized as part of inventory.

Credit Sales: The Company offers its own credit card to customers. All credit activity is performed by the Company's wholly-owned subsidiaries. None of the credit card receivables are secured. Finance income is recognized as earned under the interest method and late charges are recognized in the month in which they are assessed, net of provisions for estimated uncollectible amounts. The Company evaluates the collectibility of accounts receivable and records an allowance for doubtful accounts based on the aging of accounts and estimates of actual write-offs.

Advertising: Advertising costs are expensed in the period in which they are incurred. Advertising expense was \$6,760,000, \$6,546,000 and \$6,103,000 for the fiscal years ended February 2, 2008, February 3, 2007 and January 28, 2006, respectively.

Stock Repurchase Program: On August 30, 2007, the Company's Board of Directors authorized an increase in the stock repurchase program of two million shares, bringing total shares to repurchase to 9.581 million shares. At fiscal year end February 2, 2008, the Company had repurchased 9.186 million shares under this program, leaving 394,660 shares remaining to open authorizations. There is no specified expiration date for the Company's repurchase program. For fiscal 2007, the Company repurchased 3.162 million shares for approximately \$54.1 million or an average market price per share of \$17.11. In addition, 205,891 shares for approximately \$4.5 million or an average market price per share of \$21.70 were tendered as partial payment of the exercise price of an employee stock option and the related tax withholding.

Earnings Per Share: FASB 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 consolidated statement 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

THE CATO CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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, warrants and other convertible securities. No dilutive shares were included for the three-month period ending February 2, 2008, however, as the Company had a loss for the period and the inclusion of diluted shares would be anti-dilutive in the calculation of diluted EPS. Unvested restricted stock is included in the computation of diluted EPS using the treasury stock method.

| | Three Months Ended | | Twelve Months Ended | |
|--|-----------------------------|---------------------|-----------------------------|---------------------|
| | February 2, 2008 | February 3, 2007 | February 2, 2008 | February 3, 2007 |
| Weighted-average shares outstanding | 29,978,405 | 31,326,640 | 31,279,918 | 31,281,163 |
| Dilutive effect of : | | | | |
| Stock options | | 545,350 | 187,593 | 512,814 |
| Restricted stock | | 37,464 | 45,691 | 21,355 |
| Employee stock purchase plan | | | | |
| Weighted-average shares and common stock equivalents outstanding | 29,978,405 | 31,909,454 | 31,513,202 | 31,815,332 |

Vendor Allowances: The Company receives certain allowances from vendors primarily related to purchase discounts and markdown and damage allowances. All allowances are reflected in cost of goods sold as earned as the related products are sold in accordance with EITF 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor*. Under this EITF, cash consideration received from a vendor is presumed to be a reduction of the purchase cost of merchandise and should be reflected as a reduction of cost of sales. The Company does not receive cooperative advertising allowances.

Income Taxes: The Company files a consolidated federal income tax return. Income taxes are provided based on the asset and liability method of accounting, whereby deferred income taxes are provided for temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities.

The Company adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes (FIN 48)* an interpretation of FASB Statement No. 109, on February 4, 2007. Unrecognized tax benefits for uncertain tax positions are established in accordance with FASB Interpretation No. 48, when, despite the fact that the tax return positions are supportable, the Company believes these positions may be challenged and the results are uncertain. The Company will adjust these liabilities in light of changing facts and circumstances. As a result of the implementation of FASB Interpretation No. 48, the Company recognized a transition adjustment increasing beginning retained earnings by \$362,000.

Store Opening and Closing Costs: Costs relating to the opening of new stores or the relocating or expanding of existing stores are expensed as incurred. A portion of construction, design, and site selection costs are capitalized to

new, relocated and remodeled stores.

Closed Store Lease Obligations: At the time stores are closed, provisions are made for the rentals required to be paid over the remaining lease terms, reduced by expected sublease rentals.

Insurance: The Company is self-insured with respect to employee healthcare, workers' compensation and general liability. The Company's self-insurance liabilities are based on the total estimated cost of claims filed and estimates of claims incurred but not reported, less amounts paid against such claims, and are not discounted. Management reviews current and historical claims data in developing its estimates. The Company has stop-loss insurance coverage for individual claims in excess of \$250,000 for employee healthcare, \$350,000 for worker's compensation and \$200,000 for general liability. Employee health claims are funded through a VEBA trust to which the Company makes periodic contributions. Contributions to the VEBA trust were \$12,065,000, \$10,430,000 and

THE CATO CORPORATION**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

\$12,110,000 in fiscal 2007, 2006 and 2005, respectively. Accrued healthcare was \$1,304,000 and \$814,000 and assets held in VEBA trust were \$852,000 and \$791,000 at February 2, 2008 and February 3, 2007, respectively. The Company paid worker's compensation and general liability claims of \$4,080,000, \$3,329,000 and \$2,977,000 in fiscal years 2007, 2006 and 2005, respectively. Including claims incurred, but not yet paid, the Company recognized an expense of \$4,739,000, \$3,971,000 and \$3,518,000 in fiscal 2007, 2006 and 2005, respectively. Accrued workers compensation and general liabilities were \$4,127,000 and \$4,602,000 at February 2, 2008 and February 3, 2007, respectively. The Company had no outstanding letters of credit relating to such claims at February 2, 2008 or at February 3, 2007.

Fair Value of Financial Instruments: The Company's carrying values of financial instruments, such as cash and cash equivalents, approximate their fair values due to their short terms to maturity and/or their variable interest rates.

Recent Accounting Pronouncements

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 included: 1) 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; and 2) quarterly amortization related to all stock option awards granted subsequent to January 29, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. The impact on the Company's consolidated financial statements for fiscal 2006 was an additional compensation expense of \$235,000.

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 Standards Accounting Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109*, on February 4, 2007.

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.

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. The provisions of SFAS 159 are effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact, if any, that the adoption of SFAS 159 will have on the Company's financial statements.

THE CATO CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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 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 No. 06-11 is effective for fiscal years beginning on or after December 15, 2007. We are currently evaluating the impact that this standard may have on our results of operations and financial position.

2. Interest and Other Income:

The components of Interest and other income are shown below in gross amounts (in thousands):

| | February 2, 2008 | February 3, 2007 | January 28, 2006 |
|-----------------------------------|-----------------------------|-----------------------------|-----------------------------|
| Dividend income | \$ (17) | \$ (23) | \$ (17) |
| Interest income | (5,729) | (4,221) | (2,593) |
| Hurricane claims settlement | | (2,384) | |
| Visa/Mastercard claims settlement | | (470) | |
| Miscellaneous income | (2,207) | (2,100) | (1,836) |
| (Gain)/loss investment sales | (265) | (399) | (117) |
| Interest and other income | \$ (8,218) | \$ (9,597) | \$ (4,563) |

3. Short-Term Investments:

The Company's investment portfolio was primarily invested in 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 fair value, with unrealized gains and temporary losses reported net of taxes as accumulated other comprehensive income.

As of February 2, 2008, the Company held \$41.9 million in auction rate securities (ARS) backed by tax exempt municipal debt rated A or better. The underlying securities have contractual maturities which generally range from seven to thirty years and are classified as available for sale and recorded at fair value due to the resetting of the interest rates every 7 to 35 days. Of the \$41.9 million in ARS, \$13.9 million failed their last auction subsequent to February 2, 2008. To date, the Company has collected all interest payments on all of its ARS when due.

The Company also held \$41.5 million of governmental debt securities and \$9.0 million in VRDN's (variable rate demand notes) in managed funds as of February 2, 2008. The underlying securities of the governmental debt have contractual maturities of less than 36 months and are classified as available for sale and recorded at fair value due to

being marketable and highly liquid. The underlying securities of the VRDN s have contractual maturities from one to twenty-eight years and are classified as available for sale and recorded at fair value due to resetting every 7 to 35 days.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The table below reflects accumulated unrealized gains in short-term investments at February 2, 2008 of \$408,000 net of a deferred income tax liability of \$214,000 and accumulated unrealized losses in short-term investments at February 3, 2007 of \$34,000, net of a deferred income tax benefit of \$18,000.

| Security Type: | February 2, 2008 | | | February 3, 2007 | | |
|--|-------------------------|-----------------------------------|-------------------------------------|-------------------------|-----------------------------------|-------------------------------------|
| | Cost | Unrealized Gain/(Loss) | Estimated Fair Value | Cost | Unrealized Gain/(Loss) | Estimated Fair Value |
| Debt Securities issued by states of the United States and political subdivisions of the states: | | | | | | |
| With unrealized gain (loss) | \$ 92,373 | \$ 622 | \$ 92,995 | \$ 98,761 | \$ (52) | \$ 98,709 |
| Total | \$ 92,373 | \$ 622 | \$ 92,995 | \$ 98,761 | \$ (52) | \$ 98,709 |

Additionally, the Company had \$2.6 million invested in privately managed investment funds and other miscellaneous equities at February 2, 2008 and \$2.7 million at February 3, 2007, which are reported within other noncurrent assets in the Consolidated Balance Sheets.

Accumulated other comprehensive income in the Consolidated Balance Sheets reflects the accumulated unrealized losses in short-term investments shown above, which at February 2, 2008 was offset by unrealized gains in equity investments of \$301,000, net of a deferred income tax liability of \$157,000 and at February 3, 2007 was offset by the accumulated unrealized gains in equity investments of \$259,000, net of a deferred income tax liability of \$141,000. All investments with unrealized losses disclosed were in a loss position for less than 12 months.

As disclosed in Note 2, the Company had realized gains of \$265,000 in fiscal 2007, realized gains of \$399,000 in fiscal 2006 and realized gains of \$117,000 in fiscal 2005.

4. Accounts Receivable:

Accounts receivable consist of the following (in thousands):

| | February 2, 2008 | February 3, 2007 |
|---|-----------------------------|-----------------------------|
| Customer accounts principally deferred payment accounts | \$ 42,007 | \$ 43,939 |
| Miscellaneous trade receivables | 6,538 | 5,573 |
| Total | 48,545 | 49,512 |

| | | |
|--------------------------------------|------------------|-----------|
| Less allowance for doubtful accounts | 3,263 | 3,554 |
| Accounts receivable net | \$ 45,282 | \$ 45,958 |

Finance charge and late charge revenue on customer deferred payment accounts totaled \$10,370,000, \$10,866,000 and \$12,507,000 for the fiscal years ended February 2, 2008, February 3, 2007 and January 28, 2006, respectively, and charges against the allowance for doubtful accounts were \$2,844,000, \$2,633,000 and \$4,650,000 for the fiscal years ended February 2, 2008, February 3, 2007 and January 28, 2006, respectively. Expenses charged relating to the allowance for doubtful accounts are classified as a component of selling, general and administrative expenses in the accompanying Consolidated Statements of Income.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Property and Equipment:

Property and equipment consist of the following (in thousands):

| | February 2, 2008 | February 3, 2007 |
|---|-----------------------------|-----------------------------|
| Land and improvements | \$ 3,681 | \$ 3,266 |
| Buildings | 18,518 | 17,990 |
| Leasehold improvements | 53,938 | 51,308 |
| Fixtures and equipment | 160,688 | 158,614 |
| Information Technology equipment and software | 48,649 | 45,594 |
| Construction in progress | 1,741 | 2,833 |
| Total | 287,215 | 279,605 |
| Less accumulated depreciation | 164,025 | 151,144 |
| Property and equipment net | \$ 123,190 | \$ 128,461 |

Construction in progress primarily represents costs related to a new store development and investments in new technology.

6. Accrued Expenses:

Accrued expenses consist of the following (in thousands):

| | February 2, 2008 | February 3, 2007 |
|-----------------------------------|-----------------------------|-----------------------------|
| Accrued payroll and related items | \$ 4,476 | \$ 5,524 |
| Accrued advertising | 299 | 504 |
| Property and other taxes | 11,159 | 11,446 |
| Accrued insurance | 5,225 | 5,227 |
| Other | 6,458 | 6,825 |
| Total | \$ 27,617 | \$ 29,526 |

7. Financing Arrangements:

At February 2, 2008, the Company had an unsecured revolving credit agreement which provided for borrowings of up to \$35.0 million. This revolving credit agreement was entered into on August 22, 2003, amended October 24, 2007 and 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 February 2, 2008. There were no borrowings outstanding under this facility during the fiscal year ended February 2, 2008 or February 3, 2007. Interest is based on LIBOR, which was 3.14% on February 2, 2008.

On August 22, 2003, the Company entered into an unsecured \$30.0 million five-year term loan facility, the proceeds of which were used to purchase Class B Common Stock from the Company's founders. Payments were due in monthly installments of \$500,000 plus accrued interest. Interest was based on LIBOR. On April 5, 2005, the Company repaid the remaining balance of \$20.5 million on this loan facility. With the early retirement of this loan, the Company had no outstanding debt as of February 2, 2008 or February 3, 2007.

The Company had approximately \$4.3 million and \$4.5 million at February 2, 2008 and February 3, 2007 respectively, of outstanding irrevocable letters of credit relating to purchase commitments.

THE CATO CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. Stockholders Equity:

The holders of Class A Common Stock are entitled to one vote per share, whereas the holders of Class B Common Stock are entitled to ten votes per share. Each share of Class B Common Stock may be converted at any time into one share of Class A Common Stock. Subject to the rights of the holders of any shares of Preferred Stock that may be outstanding at the time, in the event of liquidation, dissolution or winding up of the Company, holders of Class A Common Stock are entitled to receive a preferential distribution of \$1.00 per share of the net assets of the Company. Cash dividends on the Class B Common Stock cannot be paid unless cash dividends of at least an equal amount are paid on the Class A Common Stock.

The Company's certificate of incorporation provides that shares of Class B Common Stock may be transferred only to certain Permitted Transferees consisting generally of the lineal descendants of holders of Class B Stock, trusts for their benefit, corporations and partnerships controlled by them and the Company's employee benefit plans. Any transfer of Class B Common Stock in violation of these restrictions, including a transfer to the Company, results in the automatic conversion of the transferred shares of Class B Common Stock held by the transferee into an equal number of shares of Class A Common Stock.

In April 2004, the Board of Directors adopted the 2004 Incentive Compensation Plan, of which 1,350,000 shares are issuable. As of February 2, 2008, 343,967 shares had been granted from this Plan.

In May 2003, the shareholders approved a new 2003 Employee Stock Purchase Plan with 250,000 Class A shares of Common Stock authorized. Under the terms of the Plan, substantially all associates may purchase Class A Common Stock through payroll deductions of up to 10% of their salary, up to a maximum market value of \$25,000 per year. The Class A Common Stock is purchased at the lower of 85% of market value on the first or last business day of a six-month payment period. Additionally, each April 15, associates are given the opportunity to make a lump sum purchase of up to \$10,000 of Class A Common Stock at 85% of market value. The number of shares purchased by participants through the plan were 27,164 shares, 22,873 shares and 28,684 shares for the years ended February 2, 2008, February 3, 2007 and January 28, 2006, respectively.

In December 2003, the Board of Directors authorized a dividend of one preferred share purchase right (a Right) for each share of Class A Common Stock and Class B Common Stock, each par value \$.033 per share of the Company outstanding at the close of business on January 7, 2004. In connection with the authorization of the Rights, the Company entered into a Rights Agreement, dated as of December 18, 2003 (the Rights Agreement), with American Stock Transfer & Trust Company, as Rights Agent (the Rights Agent).

The Company adopted in 1987 an Incentive Compensation Plan and a Non-Qualified Stock Option Plan for key associates of the Company. Total shares issuable under the plans are 5,850,000, of which 1,237,500 shares were issuable under the Incentive Compensation Plan and 4,612,500 shares are issuable under the Non-Qualified Stock Option Plan. The purchase price of the shares under an option must be at least 100 percent of the fair market value of Class A Common Stock at the date of the grant. Options granted under these plans vest over a 5-year period and expire 10 years after the date of the grant unless otherwise expressly authorized by the Board of Directors. As of February 2, 2008, 5,837,723 shares had been granted under the plans.

In August 1999, the Board of Directors adopted the 1999 Incentive Compensation Plan, of which 1,000,000 shares are issuable. The ability to grant awards under the 1999 Plan expired on July 31, 2004.

In May 2002, the Board of Directors approved and granted to a key executive under the 1999 Incentive Compensation Plan restricted stock awards of 150,000 shares of Class B Common Stock, with a per share fair value of \$18.21. These stock awards cliff vested after four years and the unvested portion is included in stockholders' equity as unearned compensation in the accompanying financial statements. The charge to compensation expense for these stock awards was \$-0-, \$229,000 and \$682,000 in fiscal 2007, 2006 and 2005, respectively. As of February 2, 2008, all such shares were fully vested.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Option plan activity for the three fiscal years ended February 2, 2008 is set forth below:

| | Options | Range of Option Prices | | Weighted Average Price |
|--|-------------|---------------------------|---------|------------------------------|
| Outstanding options, January 29, 2005 | 1,505,325 | \$ 5.13 | \$17.84 | \$ 8.05 |
| Granted | 22,250 | 18.96 | 21.75 | 20.05 |
| Exercised | (172,025) | 5.13 | 17.84 | 7.63 |
| Cancelled | (12,150) | 11.50 | 20.50 | 14.62 |
| Outstanding options, January 28, 2006 | 1,343,400 | 5.50 | 21.75 | 8.23 |
| Granted | | | | |
| Exercised | (95,775) | 5.50 | 21.37 | 10.12 |
| Cancelled | (10,950) | 13.47 | 21.37 | 17.24 |
| Outstanding options, February 3, 2007 | 1,236,675 | 5.50 | 21.75 | 8.01 |
| Granted | | | | |
| Exercised | (1,092,200) | 5.50 | 17.84 | 7.41 |
| Cancelled | (5,400) | 13.52 | 19.53 | 17.45 |
| Outstanding options, February 2, 2008 | 139,075 | \$ 6.39 | \$21.75 | \$ 12.41 |

The following tables summarize stock option information at February 2, 2008:

| Range of | | Options Outstanding | | | Options Exercisable | | |
|-----------------|---------|---------------------|--|--|---------------------|--|--|
| Exercise Prices | | Options | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Options | Weighted Average Exercise Price | |
| \$ 6.39 | \$ 8.96 | 42,650 | 1.49 years | \$ 8.28 | 42,650 | \$ 8.28 | |
| 11.10 | 14.79 | 74,025 | 5.67 years | 13.30 | 45,375 | 12.98 | |
| 15.08 | 19.99 | 20,900 | 6.91 years | 17.00 | 12,500 | 17.20 | |
| 21.75 | 21.75 | 1,500 | 7.08 years | 21.75 | 600 | 21.75 | |

\$ 6.39 \$21.75 139,075 4.59 years \$ 12.41 101,125 \$ 11.58

Outstanding options at February 2, 2008 covered 139,075 shares of Class A Common Stock and no shares of Class B Common Stock. Outstanding options at February 3, 2007 covered 183,675 shares of Class A Common Stock and 1,053,000 shares of Class B Common Stock. See Note 15 to the Consolidated Financial Statements for further information on the Company's Stock Based Compensation.

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.

9. Employee Benefit Plans:

The Company has a defined contribution retirement savings plan (401(k)) which covers all associates who meet minimum age and service requirements. The 401(k) plan allows participants to contribute up to 60% of their annual compensation up to the maximum elective deferral, designated by the IRS. The Company is obligated to

THE CATO CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

make a minimum contribution to cover plan administrative expenses. Further Company contributions are at the discretion of the Board of Directors. The Company's contributions for the years ended February 2, 2008, February 3, 2007 and January 28, 2006 were approximately \$1,530,000, \$1,455,000 and \$1,589,000, respectively.

The Company has an Employee Stock Ownership Plan (ESOP), which covers substantially all associates who meet minimum age and service requirements. The Board of Directors determines contributions to the ESOP. The Company's contributions for the years ended February 2, 2008, February 3, 2007 and January 28, 2006 were approximately \$-0-, \$1,789,000 and \$5,637,000, respectively.

The Company is primarily self-insured for healthcare. These costs are significant primarily due to the large number of the Company's retail locations and associates. The Company's self-insurance liabilities are based on the total estimated costs of claims filed and estimates of claims incurred but not reported, less amounts paid against such claims, and are not discounted. Management reviews current and historical claims data in developing its estimates. If the underlying facts and circumstances of the claims change or the historical trend is not indicative of future trends, then the Company may be required to record additional expense or a reduction to expense which could be material to the Company's reported financial condition and results of operations. The Company has stop-loss insurance coverage for individual claims in excess of \$250,000. Employee health claims are funded through a VEBA trust to which the Company makes periodic contributions.

10. Leases:

The Company has operating lease arrangements for store facilities and equipment. Facility leases generally are fixed rate for periods of five years with renewal options and most provide for additional contingent rentals based on a percentage of store sales in excess of stipulated amounts. For leases with landlord capital improvement funding, the funded amount is recorded as a deferred liability and amortized over the term of the lease as a reduction to rent expense on the Consolidated Statements of Income. Equipment leases are generally for one to three year periods.

The minimum rental commitments under non-cancelable operating leases are (in thousands):

Fiscal Year

| | |
|------------------------------|------------|
| 2008 | \$ 54,095 |
| 2009 | 40,312 |
| 2010 | 29,501 |
| 2011 | 19,356 |
| 2012 | 9,614 |
| Thereafter | 168 |
| Total minimum lease payments | \$ 153,046 |

The following schedule shows the composition of total rental expense for all leases (in thousands):

| Fiscal Year Ended | February 2, 2008 | February 3, 2007 | January 28, 2006 |
|--------------------------|-----------------------------|-----------------------------|-----------------------------|
| Minimum rentals | \$ 51,142 | \$ 49,169 | \$ 47,278 |
| Contingent rent | 54 | 106 | 74 |
| Total rental expense | \$ 51,196 | \$ 49,275 | \$ 47,352 |

11. Related Party Transactions:

The Company leases certain stores from entities in which Mr. George S. Currin, a director of the Company, has a controlling or non-controlling ownership interest. Rent expense and related charges totaling \$423,631, \$371,716 and \$303,612 were paid to entities controlled by Mr. Currin or his family in fiscal 2007, 2006 and 2005,

THE CATO CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

respectively, under these leases. Rent expense and related charges totaling \$1,008,664, \$939,443 and \$770,563 were paid to entities in which Mr. Currin or his family had a non-controlling ownership interest in fiscal 2007, 2006 and 2005, respectively, under these leases.

In November 2006, the Company received \$6,996,021 as payment for the purchase of a split-dollar life insurance policy by The Wayland H. Cato, Jr. Irrevocable Trust, the grantor of which is Wayland H. Cato, Jr., a Company founder and Chairman Emeritus. Mr. Cato was the insured and owned 50% of the death benefit, while the Company owned the policy and any cash value associated with it and 50% of the death benefit. The purchase was made under an agreement between the Company and the trust that allowed the trust to purchase the policy within three years of the date of Mr. Cato's termination of employment for an amount equal to the policy's cash value as of the date of transfer to the trust. Mr. Cato's employment with the Company terminated January 31, 2004.

12. Income Taxes:

The Company adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes (FIN 48)* an interpretation of FASB Statement No. 109, on February 4, 2007. Unrecognized tax benefits for uncertain tax positions are established in accordance with FIN 48, when, despite the fact that the tax return positions are supportable, the Company believes these positions may be challenged and the results are uncertain. The Company will adjust these liabilities in light of changing facts and circumstances. As a result of the implementation of FIN 48 in 2007, the Company recognized a transition adjustment increasing beginning retained earnings by \$362,000. At February 4, 2007, the Company had approximately \$6.2 million of gross unrecognized tax benefits and approximately \$3.9 million of interest and penalty accrued related to uncertain tax positions. As of February 2, 2008, the Company had gross unrecognized tax benefits totaling \$9.2 million, approximately \$5.9 million of which would affect our effective tax rate if recognized. As of February 2, 2008, the Company had approximately \$5.1 million of interest and penalties accrued related to uncertain tax positions. The Company continues to recognize interest and penalties related to uncertain tax positions in income tax expense. Generally, tax years after 2003 remain open to examination by the federal, state and local taxing jurisdictions to which the Company is subject. No significant changes are expected in the next 12 months.

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

| | In thousands |
|---|---------------------|
| Balance, February 4, 2007 | \$ 6,193 |
| Additions for tax positions of the current year | 1,686 |
| Additions for tax positions prior years | 1,301 |
| Reduction for tax positions of prior years for: | |
| Changes in judgement | |
| Settlements during the period | |
| Lapses of applicable statute of limitations | |
| Balance, February 2, 2008 | \$ 9,180 |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The provision for income taxes consists of the following (in thousands):

| Fiscal Year Ended | February 2, 2008 | February 3, 2007 | January 28, 2006 |
|--------------------------|-----------------------------|-----------------------------|-----------------------------|
| Current income taxes: | | | |
| Federal | \$ 23,800 | \$ 26,480 | \$ 27,895 |
| State | (280) | 1,205 | 1,311 |
| Total | 23,520 | 27,685 | 29,206 |
| Deferred income taxes: | | | |
| Federal | (5,902) | 443 | (3,271) |
| State | (704) | 53 | (389) |
| Total | (6,606) | 496 | (3,660) |
| Total income tax expense | \$ 16,914 | \$ 28,181 | \$ 25,546 |

Significant components of the Company's deferred tax assets and liabilities as of February 2, 2008 and February 3, 2007 are as follows (in thousands):

| | February 2, 2008 | February 3, 2007 |
|---|-----------------------------|-----------------------------|
| Deferred tax assets: | | |
| Bad debt reserve | \$ 1,227 | \$ 1,364 |
| Inventory valuation | 2,164 | 1,830 |
| Unrealized losses on short-term investments | | |
| Restricted stock options | | 184 |
| Write-down of short term investments | | |
| Capital loss carryover | 274 | 393 |
| Other | | |
| Deferred lease liability | 9,148 | 5,277 |
| Reserves | 3,817 | 2,245 |
| Other taxes | 1,203 | 1,932 |
| Federal Benefit of FIN 48 | 3,906 | |
| Equity Compensation Expense | 1,297 | 651 |
| Total deferred tax assets | 23,036 | 13,876 |

| | | |
|---|-------------------|-----------------|
| Deferred tax liabilities: | | |
| Fixed assets | 16,010 | 13,489 |
| Unrealized gains (losses) on short-term investments | 371 | 123 |
| Other | 1,606 | 1,573 |
| Total deferred tax liabilities | 17,987 | 15,185 |
| Net deferred tax liabilities (assets) | \$ (5,049) | \$ 1,309 |

Capital loss carryovers included in the Company's deferred tax assets have a limited life and will expire in 2009 if not utilized. The Company believes realization is more likely than not.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The reconciliation of the Company's effective income tax rate with the statutory rate is as follows:

| Fiscal Year Ended | February 2, 2008 | February 3, 2007 | January 28, 2006 |
|---------------------------|-----------------------------|-----------------------------|-----------------------------|
| Federal income tax rate | 35.0% | 35.0% | 35.0% |
| State income taxes | 7.7 | 2.4 | 3.2 |
| Tax Credits | (3.1) | (1.3) | (0.4) |
| Federal benefit of FIN 48 | (9.0) | | |
| Other | 3.8 | (0.7) | (1.5) |
| Effective income tax rate | 34.4% | 35.4% | 36.3% |

13. Quarterly Financial Data (Unaudited):

Summarized quarterly financial results are as follows (in thousands, except per share data):

| Fiscal 2007 | First | Second | Third | Fourth |
|--|--------------|---------------|--------------|---------------|
| Retail sales | \$ 224,134 | \$ 218,973 | \$ 181,870 | \$ 209,364 |
| Total revenues | 227,228 | 221,934 | 184,838 | 212,436 |
| Cost of goods sold (exclusive of depreciation) | 143,422 | 147,514 | 126,080 | 155,294 |
| Income before income taxes | 29,172 | 18,650 | 3,947 | (2,538) |
| Net income | 18,670 | 12,510 | 2,936 | (1,798) |
| Basic earnings per share | \$ 0.60 | \$ 0.39 | \$ 0.09 | \$ (0.06) |
| Diluted earnings per share | \$ 0.59 | \$ 0.39 | \$ 0.09 | \$ (0.06) |

| Fiscal 2006 | First | Second | Third | Fourth |
|--|--------------|---------------|--------------|---------------|
| Retail sales | \$ 229,741 | \$ 214,633 | \$ 187,727 | \$ 230,712 |
| Total revenues | 233,060 | 217,845 | 190,882 | 234,097 |
| Cost of goods sold (exclusive of depreciation) | 142,113 | 143,746 | 127,229 | 159,625 |
| Income before income taxes | 32,754 | 19,044 | 9,133 | 18,698 |
| Net income | 20,799 | 12,093 | 5,861 | 12,696 |
| Basic earnings per share | \$ 0.67 | \$ 0.39 | \$ 0.19 | \$ 0.41 |
| Diluted earnings per share | \$ 0.65 | \$ 0.38 | \$ 0.18 | \$ 0.40 |

THE CATO CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

14. Reportable Segment Information:

The Company has two reportable segments: retail and credit. The Company operates its women's fashion specialty retail stores in 32 states, principally in southeastern United States. The Company offers its own credit card to its customers and all 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):

| Fiscal 2007 | Retail | Credit | Total |
|---------------------------|---------------|---------------|--------------|
| Revenues | \$ 836,023 | \$ 10,414 | \$ 846,437 |
| Depreciation | 22,112 | 100 | 22,212 |
| Interest and other income | (8,218) | | (8,218) |
| Income before taxes | 44,983 | 4,250 | 49,233 |
| Total assets | 354,001 | 68,491 | 422,492 |
| Capital expenditures | 18,211 | 119 | 18,330 |
| | | | |
| Fiscal 2006 | Retail | Credit | Total |
| Revenues | \$ 864,987 | \$ 10,898 | \$ 875,885 |
| Depreciation | 20,849 | 92 | 20,941 |
| Interest and other income | (9,597) | 0 | (9,597) |
| Income before taxes | 74,772 | 4,859 | 79,631 |
| Total assets | 368,786 | 63,536 | 432,322 |
| Capital expenditures | 27,483 | 64 | 27,547 |
| | | | |
| Fiscal 2005 | Retail | Credit | Total |
| Revenues | \$ 823,685 | \$ 12,696 | \$ 836,381 |
| Depreciation | 20,173 | 102 | 20,275 |
| Interest and other income | (4,563) | 0 | (4,563) |
| Income before taxes | 65,682 | 4,693 | 70,375 |
| Total assets | 339,788 | 66,848 | 406,636 |
| Capital expenditures | 28,477 | 35 | 28,512 |

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company evaluates performance based on profit or loss from operations before income taxes. The Company does not allocate certain corporate expenses to the credit segment.

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

| | February 2, 2008 | February 3, 2007 | January 28, 2006 |
|------------------|-----------------------------|-----------------------------|-----------------------------|
| Bad debt expense | \$ 2,844 | \$ 2,633 | \$ 4,650 |
| Payroll | 983 | 1,008 | 1,043 |
| Postage | 985 | 1,034 | 1,061 |
| Other expenses | 1,252 | 1,272 | 1,147 |
| Total expenses | \$ 6,064 | \$ 5,947 | \$ 7,901 |

THE CATO CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

15. 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 includes: 1) 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; and 2) quarterly amortization related to all stock option awards granted subsequent to January 29, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R.

As of February 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 associates. 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 associates. 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 to grant under each of the plans as of February 2, 2008:

| | 1987 Plan | 1999 Plan | 2004 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 |
| February 2, 2008 | 12,277 | | 1,006,033 | 1,018,310 |

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.

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

Weighted Average Aggregate

| | Shares | Weighted Average Exercise Price | Remaining Contractual Term | Intrinsic Value(a) |
|--|---------------|--|---|-------------------------------|
| Options outstanding at February 3, 2007 | 1,236,675 | \$ 8.01 | 1.86 years | \$ 18,363,084 |
| Granted | | | | |
| Forfeited or expired | 5,400 | 17.45 | | |
| Exercised | 1,092,200 | 7.41 | | |
| Outstanding at February 2, 2008 | 139,075 | \$ 12.41 | 4.64 years | \$ 494,087 |
| Vested and exercisable at February 2, 2008 | 101,125 | \$ 11.58 | 3.94 years | \$ 443,411 |

- (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.

THE CATO CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

No options were granted in fiscal 2007 and no options were granted in fiscal 2006. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model.

As of February 2, 2008, there was approximately \$164,505 of total unrecognized compensation cost related to nonvested options, which is expected to be recognized over a remaining weighted-average vesting period of 1.43 years. The total intrinsic value of options exercised in fiscal 2007 was approximately \$15,390,000.

Effective January 29, 2006, 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 \$435,000 and \$1,715,000 for the fourth quarter and twelve month period ended February 2, 2008, respectively, which was classified as a component of selling, general and administrative expenses. No share-based compensation expense was recognized prior to January 29, 2006 except for the amortization of restricted stock grants.

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 twelve months ended February 2, 2008, the Company reported \$5,964,000 of excess tax benefits as a financing cash inflow in addition to \$8,591,000 in cash proceeds received from the exercise of stock options and Employee Stock Purchase Plan purchases.

The Company's Employee Stock Purchase Plan allows eligible full-time associates 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 twelve months ended February 2, 2008, the Company sold 27,164 shares to associates at an average discount of \$3.87 per share under the Employee Stock Purchase Plan. The compensation expense recognized for the 15% discount given under the Employee Stock Purchase Plan was approximately \$85,000 for fiscal 2007 compared to \$73,000 for fiscal 2006. Prior to the adoption of SFAS 123R, the discount was not required to be charged to expense.

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 February 2, 2008, there was \$4,913,000 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 3.49 years. The total fair value of the shares recognized as compensation expense during the fourth quarter and twelve months ended February 2, 2008 was \$398,000 and \$1,493,000, respectively.

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

| Number of Shares | Weighted Average Grant Date Fair Value Per Share |
|-------------------------|---|
|-------------------------|---|

| | | | |
|---|---------|----|-------|
| Restricted stock awards at February 3, 2007 | 214,882 | \$ | 22.92 |
| Granted | 102,399 | | 21.41 |
| Vested | | | |
| Forfeited | 15,314 | | 19.90 |
| Restricted stock awards at February 2, 2008 | 301,967 | \$ | 22.56 |

16. Commitments and Contingencies:

Workers compensation and general liability claims are settled through a claims administrator and are limited by stop-loss insurance coverage for individual claims in excess of \$350,000 and \$200,000, respectively. The Company paid claims of \$4,080,000, \$3,329,000 and \$2,977,000 in fiscal 2007, 2006 and 2005, respectively.

THE CATO CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Including claims incurred, but not yet paid, the Company recognized an expense of \$4,739,000, \$3,971,000 and \$3,518,000 in fiscal 2007, 2006 and 2005, respectively. Accrued workers compensation and general liabilities was \$4,127,000 and \$4,602,000 at February 2, 2008 and February 3, 2007, respectively. The Company had no outstanding letters of credit relating to such claims at February 2, 2008 or at February 3, 2007. See Note 7 for letters of credit related to purchase commitments, Note 9 for 401(k) plan contribution obligations and Note 10 for lease commitments.

The Company does not have any guarantees with third parties. The Company has placed a \$2.0 million deposit with Cedar Hill National Bank (Cedar Hill), a wholly owned subsidiary, as security and collateral for the payment of amounts due from CatoWest LLC, a wholly owned subsidiary, to Cedar Hill. The deposit has no set term. The deposit was made at the request of the Office of the Comptroller of the Currency because the receivable is not settled immediately and Cedar Hill has a risk of loss until payment is made. CatoWest LLC purchases receivables from Cedar Hill on a daily basis (generally one day in arrears). In the event CatoWest LLC fails to transfer to Cedar Hill the purchase price for any receivable within two business days, Cedar Hill has the right to withdraw any amount necessary from the account established by the Company to satisfy the amount due Cedar Hill from CatoWest LLC. Although the amount of potential future payments is limited to the amount of the deposit, Cedar Hill may require, at its discretion, the Company to increase the amount of the deposit with no limit on the increase. The deposit is based upon the amount of payments that would be due from CatoWest LLC to Cedar Hill for the highest credit card sales weekends of the year that would remain unpaid until the following business day. The Company has no obligations related to the deposit at year-end. No recourse provisions exist nor are any assets held as collateral that would reimburse the Company if Cedar Hill withdraws a portion of the deposit.

In addition, the Company has \$5.0 million in escrow with Branch Banking & Trust Co. on behalf of Zurich American Insurance Company as security and collateral for administration of the Company's self-insured workers compensation and general liability coverage.

The Company is a defendant in legal proceedings considered to be in the normal course of business and none of which, singularly or collectively, are expected to have a material effect on the Company's results of operations, cash flows and financial position.

Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure:*

None.

Item 9A. *Controls and Procedures:*

Conclusion Regarding the Effectiveness of Disclosure 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 February 2, 2008. Based on this evaluation, our principal executive officer and principal financial officer concluded that, as of February 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.

Management's Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we carried out an evaluation of the effectiveness of our internal control over financial reporting as of February 2, 2008 based on the *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this evaluation, our management concluded that our internal control over financial reporting was effective as of February 2, 2008.

PricewaterhouseCoopers LLP, our independent registered public accounting firm, has audited the effectiveness of our internal control over financial reporting as of February 2, 2008, as stated in their report which is included herein.

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 February 2, 2008 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Item 9B. *Other Information:*

None.

PART III

Item 10. *Directors, Executive Officers and Corporate Governance:*

Information contained under the captions Election of Directors, Meetings and Committees, Corporate Governance Matters and Section 16(a) Beneficial Ownership Reporting and Compliance in the Registrant's Proxy Statement for its 2008 annual stockholders meeting (the 2008 Proxy Statement) is incorporated by reference in response to this Item 10. The information in response to this Item 10 regarding executive officers of the Company is contained in Item 4A,

Part I hereof under the caption Executive Officers of the Registrant.

Item 11. *Executive Compensation:*

Information contained under the captions Executive Compensation in the Company's 2008 Proxy Statement is incorporated by reference in response to this Item.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters:**Equity Compensation Plan Information.**

The following table provides information about stock options outstanding and shares available for future awards under all of Cato's equity compensation plans. The information is as of February 2, 2008.

| Plan Category | (a) Number of Securities to be Issued upon Exercise of Outstanding Options, Warrants and Rights(1) | (b) Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights(1) | (c) |
|--|---|---|--|
| | | | Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (2) |
| Equity compensation plans approved by security holders | 139,075 | \$ 12.41 | 1,272,220 |
| Equity compensation plans not approved by security holders | | | |
| Total | 139,075 | \$ 12.41 | 1,272,220 |

(1) This column contains information regarding employee stock options only; there are no outstanding warrants or stock appreciation rights.

(2) Includes the following:

1,006,033 shares available for grant under the Company's stock incentive plan, referred to as the 2004 Incentive Compensation Plan. Under this plan, non-qualified stock options may be granted to key associates. Additionally, 12,277 shares available for grant under the Company's stock incentive plan, referred to as the 1987 Non-qualified Stock Option Plan. Stock options have terms of 10 years, vest evenly over 5 years, and are assigned an exercise price of not less than the fair market value of the Company's stock on the date of grant; and

253,910 shares available under the 2003 Employee Stock Purchase Plan. Eligible associates may participate in the purchase of designated shares of the Company's common stock. The purchase price of this stock is equal to 85% of the lower of the closing price at the beginning or the end of each semi-annual stock purchase period.

Information contained under Security Ownership of Certain Beneficial Owners and Management in the 2008 Proxy Statement is incorporated by reference in response to this Item.

Item 13. *Certain Relationships and Related Transactions and Director Independence:*

Information contained under the caption *Related Party Transactions* and *Director Independence* in the 2008 Proxy Statement is incorporated by reference in response to this Item.

Item 14. *Principal Accountant Fees and Services:*

The information required by this Item is incorporated herein by reference to the section entitled *Audit Fees* and *Policy on Audit Committee Pre-Approval of Audit and Permissible Non-Audit Service by the Independent Auditor* in the 2008 Proxy Statement.

PART IV

Item 15. Exhibits and Financial Statement Schedules:

(a) The following documents are filed as part of this report:

(1) Financial Statements:

| | Page |
|---|-------------|
| Report of Independent Registered Public Accounting Firm | 24 |
| Consolidated Statements of Income and Comprehensive Income for the fiscal years ended February 2, 2008, February 3, 2007 and January 28, 2006 | 25 |
| Consolidated Balance Sheets at February 2, 2008 and February 3, 2007 | 26 |
| Consolidated Statements of Cash Flows for the fiscal years ended February 2, 2008, February 3, 2007, and January 28, 2006 | 27 |
| Consolidated Statements of Stockholders' Equity for the fiscal years ended February 2, 2008, February 3, 2007, and January 28, 2006 | 28 |
| Notes to Consolidated Financial Statements | 29 |

(2) Financial Statement Schedule: The following report and financial statement schedule is filed herewith:
 Schedule II Valuation and Qualifying Accounts S-2

All other schedules are omitted as the required information is inapplicable or the information is presented in the consolidated financial statements or related notes thereto.

(3) Index to Exhibits: The following exhibits are filed with this report or, as noted, incorporated by reference herein. The Company will supply copies of the following exhibits to any shareholder upon receipt of a written request addressed to the Corporate Secretary, The Cato Corporation, 8100 Denmark Road, Charlotte, NC 28273 and the payment of \$.50 per page to help defray the costs of handling, copying and postage. In most cases, documents incorporated by reference to exhibits to our registration statements, reports or proxy statements filed by the Company with the Securities and Exchange Commission are available to the public over the Internet from the SEC's web site at <http://www.sec.gov>. You may also read and copy any such document at the SEC's public reference room located at Room 1580, 100 F. Street, N.E., Washington, D.C. 20549 under the Company's SEC file number (1-31340).

Registrant 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. 33-11111)
 Registrant's By Laws incorporated by reference to Exhibit 4.2 to Form S-8 of the Registrant filed February 7, 2000 (SEC File No. 33-11111)
 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
 plan dated August 26, 1999, incorporated by reference to Exhibit 4.3 to Form S-8 of the Registrant filed February 7, 2000 (SEC File No. 33-11111)
 dated as of August 29, 2003, between the Registrant and Wayland H. Cato, Jr., incorporated by reference to Exhibit 99(c) to Form 8-K of the Registrant
 dated as of August 29, 2003, between the Registrant and Edgar T. Cato, incorporated by reference to Exhibit 99(d) to Form 8-K of the Registrant
 Retirement Agreement between Registrant and Wayland H. Cato, Jr. dated August 29, 2003 incorporated by reference to Exhibit 99(e) to Form 8-K of the Registrant

Retirement Agreement between Registrant and Edgar T. Cato dated August 29, 2003, incorporated by reference to Exhibit 10.2 to Form
Termination Agreement between Registrant and Reynolds C. Faulkner dated as of October 30, 2006, incorporated by reference to Exhibit 99
Letter Agreement between Registrant and Thomas W. Stoltz dated as of December 4, 2006, incorporated by reference to Exhibit 99.1
on Determinations, incorporated by reference to Item 5.02 of Form 8-K filed April 4, 2007.

Subsidiaries of Registrant.

ent of Independent Registered Public Accounting Firm.

4(a)/15d-14(a) Certification of Chief Executive Officer.

4(a)/15d-14(a) Certification of Chief Financial Officer.

Section 1350 Certification of Chief Executive Officer.

Section 1350 Certification of Chief Financial Officer.

* Management contract or compensatory plan required to be filed under Item 15 of this report and Item 601 of Regulation S-K.

EXHIBIT INDEX

| Designation of Exhibit | | Page |
|-----------------------------------|---|-------------|
| 21 | Subsidiaries of the Registrant | 53 |
| 23.1 | Consent of Independent Registered Public Accounting Firm | 54 |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer | 55 |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer | 56 |
| 32.1 | Section 1350 Certification of Chief Executive Officer | 57 |
| 32.2 | Section 1350 Certification of Chief Financial Officer | 58 |

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, Cato has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

The Cato Corporation

By
/s/ JOHN P. D. CATO

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

By
/s/ THOMAS W. STOLTZ

Thomas W. Stoltz
Executive Vice President
Chief Financial Officer

By
/s/ JOHN R. HOWE

John R. Howe
Senior Vice President
Controller

Date: April 1, 2008

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the date indicated:

/s/ JOHN P. D. CATO

John P. D. Cato
(President and Chief Executive Officer
(Principal Executive Officer) and Director)

/s/ WILLIAM H. GRIGG

William H. Grigg
(Director)

/s/ THOMAS W. STOLTZ

Thomas W. Stoltz
(Executive Vice President
Chief Financial Officer (Principal Financial Officer))

/s/ GRANT L. HAMRICK

Grant L. Hamrick
(Director)

/s/ JOHN R. HOWE

John R. Howe
(Senior Vice President
Controller (Principal Accounting Officer))

/s/ JAMES H. SHAW

James H. Shaw
(Director)

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/s/ ROBERT W. BRADSHAW, JR.

/s/ A.F. (PETE) SLOAN

Robert W. Bradshaw, Jr.
(Director)

A.F. (Pete) Sloan
(Director)

/s/ GEORGE S. CURRIN

/s/ D. HARDING STOWE

George S. Currin
(Director)

D. Harding Stowe
(Director)

SCHEDULE II

VALUATION AND QUALIFYING ACCOUNTS

| | Allowance for Doubtful Accounts(a) | Self Insurance Reserves(b) |
|--|---|---------------------------------------|
| Balance at January 29, 2005 | \$ 6,122 | \$ 4,155 |
| Additions charged to costs and expenses | 4,650 | 3,518 |
| Additions (reductions) charged to other accounts | 1,117(c) | (46) |
| Deductions | (8,195)(d) | (2,977) |
| | | |
| Balance at January 28, 2006 | 3,694 | 4,650 |
| Additions charged to costs and expenses | 2,633 | 3,971 |
| Additions (reductions) charged to other accounts | 1,600(c) | (690) |
| Deductions | (4,373)(d) | (3,329) |
| | | |
| Balance at February 3, 2007 | 3,554 | 4,602 |
| Additions charged to costs and expenses | 2,844 | 4,739 |
| Additions (reductions) charged to other accounts | 1,038(c) | (1,134) |
| Deductions | (4,173)(d) | (4,080) |
| | | |
| Balance at February 2, 2008 | \$ 3,263 | \$ 4,127 |

- (a) Deducted from trade accounts receivable.
- (b) Reserve for Workers Compensation and General Liability.
- (c) Recoveries of amounts previously written off.
- (d) Uncollectible accounts written off.