DOLLAR GENERAL CORP
Form 10-Q
June 01, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT

PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended May 5, 2006

Commission file number: 001-11421

DOLLAR GENERAL CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

TENNESSEE	**61-0502302**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification No.)*

100 MISSION RIDGE
GOODLETTSVILLE, TENNESSEE 37072
(Address of Principal Executive Offices, Zip Code)

Registrant s telephone number, including area code: (615) 855-4000

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer [X]

Accelerated filer [ ]

Non-accelerated filer [ ]

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

The number of shares of common stock outstanding on May 26, 2006, was 311,756,653.

PART I FINANCIAL INFORMATION

ITEM 1.

FINANCIAL STATEMENTS

DOLLAR GENERAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	May 5, 2006	February 3, 2006
ASSETS	(Unaudited)	
Current assets:		
Cash and cash equivalents	$ 71,876	$ 200,609
Short-term investments	18,825	8,850
Merchandise inventories	1,636,118	1,474,414
Deferred income taxes	2,367	11,912
Prepaid expenses and other current assets	79,569	67,140
Total current assets	1,808,755	1,762,925
Net property and equipment	1,212,386	1,192,172
Other assets, net	42,326	37,090
Total assets	$ 3,063,467	$ 2,992,187
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term obligations	$ 8,800	$ 8,785
Accounts payable	569,447	508,386
Accrued expenses and other	379,218	372,920
Income taxes payable	22,027	43,706
Total current liabilities	979,492	933,797
Long-term obligations	333,471	269,962
Deferred income taxes	63,690	67,633
Shareholders equity:		
Preferred stock	-	-

Common stock	155,859	157,840
Additional paid-in capital	470,878	462,383
Retained earnings	1,060,427	1,106,165
Accumulated other comprehensive loss	(740)	(794)
Other shareholders equity	390	(4,799)
Total shareholders equity	1,686,814	1,720,795
Total liabilities and shareholders equity	$ 3,063,467	$ 2,992,187

See notes to condensed consolidated financial statements.

DOLLAR GENERAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(In thousands except per share amounts)

	For the 13 weeks ended	
	May 5, 2006	April 29, 2005
Net sales	$ 2,151,387	$ 1,977,829
Cost of goods sold	1,567,113	1,414,480
Gross profit	584,274	563,349
Selling, general and administrative	502,989	456,428
Operating profit	81,285	106,921
Interest income	(2,450)	(2,616)
Interest expense	7,247	5,968
Income before income taxes	76,488	103,569
Income taxes	28,818	38,669
Net income	$ 47,670	$ 64,900
Earnings per share:		
Basic	$ 0.15	$ 0.20
Diluted	$ 0.15	$ 0.20
Weighted average shares outstanding:		
Basic	313,997	328,208
Diluted	315,233	331,218
Dividends per share	$ 0.05	$ 0.04

See notes to condensed consolidated financial statements.

DOLLAR GENERAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	For the 13 weeks ended May 5, 2006	For the 13 weeks ended April 29, 2005
Cash flows from operating activities:		
Net income	$ 47,670	$ 64,900
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	48,778	44,006
Deferred income taxes	5,602	3,340
Tax benefit from stock option exercises	(1,461)	2,967
Change in operating assets and liabilities:		
Merchandise inventories	(161,704)	(89,444)
Prepaid expenses and other current assets	(12,429)	(5,464)
Accounts payable	69,467	60,526
Accrued expenses and other	6,118	(10,824)
Income taxes	(20,236)	(15,086)
Other	2,079	199
Net cash provided by (used in) operating activities	(16,116)	55,120
Cash flows from investing activities:		
Purchases of property and equipment	(77,102)	(65,061)
Purchases of short-term investments	(10,476)	(21,250)
Sales of short-term investments	6,000	64,175
Purchases of long-term investments	(10,809)	-
Proceeds from sale of property and equipment	303	122
Net cash used in investing activities	(92,084)	(22,014)
Cash flows from financing activities:		
Borrowings under revolving credit facilities	116,500	-
Repayments of borrowings under revolving credit facilities	(51,500)	-
Repayments of long-term obligations	(2,364)	(4,722)
Payment of cash dividends	(15,686)	(13,145)
Proceeds from exercise of stock options	10,934	13,494
Repurchases of common stock	(79,947)	(25,062)

Tax benefit from stock option exercises		1,461		-
Other financing activities		69		22
Net cash used in financing activities		(20,533)		(29,413)
Net increase (decrease) in cash and cash equivalents		(128,733)		3,693
Cash and cash equivalents, beginning of period		200,609		232,830
Cash and cash equivalents, end of period	$	71,876	$	236,523
Supplemental schedule of noncash investing and financing activities:				
Purchases of property and equipment awaiting processing for payment, included in Accounts payable	$	16,344	$	2,810
Purchases of property and equipment under capital lease obligations	$	877	$	578

See notes to condensed consolidated financial statements.

DOLLAR GENERAL CORPORATION AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1.

Basis of presentation and accounting policies

Basis of presentation

The accompanying unaudited condensed consolidated financial statements of Dollar General Corporation and its subsidiaries (the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and are presented in accordance with the requirements of Form 10-Q and Rule 10-01 of Regulation S-X. Such financial statements consequently do not include all of the disclosures normally required by GAAP or those normally made in the Company s Annual Report on Form 10-K. Accordingly, the reader of this Quarterly Report on Form 10-Q should refer to the Company s Annual Report on Form 10-K for the year ended February 3, 2006 for additional information.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the Company s customary accounting practices. In management s opinion, all adjustments (which are of a normal recurring nature) necessary for a fair presentation of the consolidated financial position and results of operations for the 13-week periods ended May 5, 2006 and April 29, 2005 have been made.

Certain prior amounts have been reclassified to conform to the current period presentation. Ongoing estimates of inventory shrinkage and initial markups and markdowns are included in the interim cost of goods sold calculation. Because the Company s business is moderately seasonal, the results for interim periods are not necessarily indicative of the results to be expected for the entire year.

2.

Share-based payments

The Company has a shareholder-approved stock incentive plan under which stock options, nonvested shares in the form of restricted stock and restricted stock units (which represent the right to receive one share of common stock for each unit upon vesting), and other equity-based awards may be granted to certain officers, directors and key employees. The plan authorizes the issuance of up to 29.375 million shares of the Company s common stock, up to 4 million of which may be issued in the form of restricted stock or restricted stock units. As of May 5, 2006, there were approximately 5.5 million shares available for future grant, approximately 3.4 million of which may be issued as restricted stock or restricted stock units. The Company believes that stock-based awards assist in retaining employees and better align the interests of its employees with those of its shareholders.

Stock options granted under the plan are generally non-qualified stock options issued at an exercise price equal to the market price of the Company s common stock on the grant date, vest ratably over a four-year period (subject to earlier vesting upon a change in control), and expire no more than 10 years following the grant date (subject to earlier termination upon death, disability or cessation of employment). The number of options granted is based on individual job grade levels, which are determined based upon competitive market data. Dividends are not paid or accrued on stock options.

Unvested options generally are forfeited upon the cessation of an optionee s employment with the Company. In the event an optionee s employment terminates for a reason other than cause, death, disability or retirement (each of cause, disability and retirement as defined in the plan), that optionee generally may exercise any outstanding vested options issued under the plan for a period of three months. In the event an optionee s employment terminates due to death, disability or retirement (each of disability and retirement as defined in the plan), that optionee generally may exercise any outstanding vested options issued under the plan for a period of three years. Notwithstanding the foregoing, no option may be exercised beyond its initial 10-year expiration date.

Restricted stock awards and restricted stock unit awards granted under the plan generally vest ratably over three years (subject to earlier vesting upon a change in control). Unvested restricted stock and restricted stock unit awards generally are forfeited upon the cessation of a grantee s employment with the Company. Recipients of restricted stock are entitled to receive cash dividends and to vote their respective shares, but are generally prohibited from selling or transferring restricted shares prior to vesting. Recipients of restricted stock units are entitled to accrue dividend equivalents on the units but are not entitled to vote, sell or transfer the shares underlying the units prior to both vesting and payout. Dividends or dividend equivalents, as the case may be, are paid or accrued on the grants of restricted stock and restricted stock units at the same rate that dividends are paid to shareholders generally. Dividend equivalents on restricted stock units vest at the same time that the underlying shares vest.

The plan provides for the automatic annual grant of 4,600 restricted stock units to each non-employee director (6,000 restricted stock units to any non-employee director serving as Chairman) that generally vest one year after the grant date (subject to earlier vesting upon retirement, change in control or other circumstances set forth in the plan) and are paid after the individual has ceased to be a member of the Company s Board of Directors.

On February 3, 2006, the vesting of all outstanding options granted prior to August 2, 2005, other than options previously granted to the Company s CEO and options granted in 2005 to the officers of the Company at the level of Executive Vice President or above, accelerated pursuant to a January 24, 2006 action of the Compensation Committee of the Company s Board of Directors. In addition, pursuant to that Compensation Committee action, the vesting of all outstanding options granted on or after August 2, 2005 but prior to January 24, 2006, other than options granted during that time period to the officers of the Company at the level of Executive Vice President or above, accelerated effective as of the date that is six months after the applicable grant date. Certain options granted on January 24, 2006 to certain newly hired officers below the level of Executive Vice President were granted with a six-month vesting period. The decision to accelerate stock options resulted in compensation expense of $0.9 million, before income taxes, recognized during the fourth quarter of 2005, and was made primarily to reduce non-cash compensation expense to be recorded in future periods under the provisions of

Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment . The future expense eliminated as a result of the decision to accelerate the vesting of these options was approximately $28 million, or $17 million net of income taxes, over the four-year period during which the stock options would have vested, subject to the impact of additional adjustments related to certain stock option forfeitures. The Company also believes this decision benefits employees.

Effective February 4, 2006, the Company adopted SFAS 123(R) and began recognizing compensation expense for stock options based on the fair value of the awards on the grant date. SFAS 123(R) requires share-based compensation expense recognized since February 4, 2006 to be based on the following: (a) grant date fair value estimated in accordance with the original provisions of SFAS 123, Accounting for Stock-Based Compensation, for unvested options granted prior to the adoption date and (b) grant date fair value estimated in accordance with the provisions of SFAS 123(R) for unvested options granted subsequent to the adoption date. Prior to February 4, 2006, the Company accounted for share-based payments using the intrinsic-value-based recognition method prescribed by Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25) and had provided proforma disclosures as permitted under SFAS 123. Because stock options were granted at an exercise price equal to the market price of the underlying common stock on the date of grant, compensation cost related to stock options was not reflected in net income prior to adopting SFAS 123(R), except for fiscal 2005 compensation expense of $0.9 million, before income taxes, related to the accelerated vesting of stock options discussed above.

The Company adopted SFAS 123(R) under the modified-prospective-transition method and therefore results from prior periods have not been restated. The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS 123 to options granted under the Company's stock plans for the 13-week period ended April 29, 2005. For purposes of this pro forma disclosure, the value of the options is estimated using the Black-Scholes-Merton option pricing model for all option grants.

(Amounts in thousands except per share data)		13 Weeks Ended April 29, 2005
Net income as reported	$	64,900
Deduct: Total pro forma stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects per SFAS 123		(2,586)
Net income pro forma	$	62,314
Earnings per share as reported		
Basic	$	0.20
Diluted	$	0.20
Earnings per share pro forma		
Basic	$	0.19
Diluted	$	0.19

Under SFAS 123(R) forfeitures are estimated at the time of valuation and reduce expense ratably over the vesting period. This estimate is adjusted periodically based on the extent to which actual forfeitures differ, or are expected to differ, from the previous estimate.

The forfeiture rate is the estimated percentage of options granted that are expected to be forfeited or canceled before becoming fully vested. The Company bases this estimate on historical experience. An increase in the forfeiture rate will decrease compensation expense. Under SFAS 123, the Company elected to account for forfeitures when awards were actually forfeited, at which time all previous pro forma expense (which after-tax, approximated $1.7 million in the 13-week period ended April 29, 2005) was reversed to reduce pro forma expense for that period.

For the 13-week period ended May 5, 2006, the adoption of the fair value method of SFAS 123(R) resulted in additional share-based compensation expense (a component of SG&A expenses) and a corresponding reduction of pre-tax income in the amount of $1.0 million, a reduction of net income of $0.6 million, and a reduction in basic and diluted earnings per share of less than $0.01.

SFAS 123(R) also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required prior to the adoption of SFAS 123(R). For the 13-week period ended May 5, 2006, the $1.5 million excess tax benefit classified as a financing cash inflow would have been classified as an operating cash inflow if the Company had not adopted SFAS 123(R). The impact of the adoption of SFAS 123(R) on future results will depend on, among other things, levels of share-based payments granted in the future, actual forfeiture rates and the timing of option exercises.

The fair value of each option grant is separately estimated. The fair value of each option is amortized into compensation expense on a straight-line basis between the grant date for the award and each vesting date. The Company has estimated the fair value of all stock option awards as of the date of the grant by applying the Black-Scholes-Merton option pricing valuation model. The application of this valuation model involves assumptions that are judgmental and highly sensitive in the determination of compensation expense. The weighted average for key assumptions used in determining the fair value of options granted in the 13-week period ended May 5, 2006 and a summary of the methodology applied to develop each assumption are as follows. Assumptions used for grants in the prior year period were derived using methodologies prescribed by SFAS 123 and are presented for purposes of comparability.

	13 Weeks Ended	
	May 5, 2006	April 29, 2005
Expected dividend yield	0.82 %	0.85 %
Expected stock price volatility	28.7 %	27.4 %
Weighted average risk-free interest rate	4.7 %	4.3 %
Expected term of options (years)	5.7	5.0

Expected dividend yield This is an estimate of the expected dividend yield on the Company s stock. This estimate is based on historical dividend payment trends. An increase in the dividend yield will decrease compensation expense.

Expected stock price volatility - This is a measure of the amount by which a price has fluctuated or is expected to fluctuate. The Company uses actual historical changes in the market price of the Company s common stock and implied volatility based upon traded options, weighted equally, to calculate the volatility assumption, as it is the Company's belief that this methodology provides the best indicator of future volatility. For historical volatility, the Company calculates daily market price changes from the date of grant over a past period representative of the expected life of the options to determine volatility, excluding the period from April 30, 2001 to January 31, 2002 due to a restatement of the Company s financial statements for fiscal years 2001 and prior and due to the Company s inability, during a substantial portion of this period, to file annual and quarterly reports required by the Securities and Exchange Act of 1934. The Company believes that the restatement and related inability to file periodic Exchange Act reports is an event specific to the Company that resulted in higher than normal share price volatility during this period and is not expected to recur during the estimated term of current option grants. An increase in the expected volatility will increase compensation expense.

Weighted average risk-free interest rate - This is the U.S. Treasury rate for the week of the grant having a term approximating the expected life of the option. An increase in the risk-free interest rate will increase compensation expense.

Expected term of options - This is the period of time over which the options granted are expected to remain outstanding. Because the terms of the Company s stock option grants prior to August 2002 were significantly different than grants issued on and after that date and the Company does not currently intend to grant stock options similar to those granted prior to August 2002 in future periods, the Company believes that the historical and post-vesting employee behavior patterns for grants prior to August 2002 are of little or no value in determining future expectations and therefore has generally excluded these pre-August 2002 grants from its analysis of expected term. The Company has estimated expected term using a computation based on an assumption that outstanding options will be exercised approximately halfway through their contractual term, taking into consideration such factors as grant date, expiration date, weighted-average time-to-vest, actual exercises and post-vesting cancellations. Options granted generally have a maximum term of ten years. An increase in the expected term will increase compensation expense.

The Company generally issues new shares when options are exercised. A summary of stock option activity during the 13 weeks ended May 5, 2006 is as follows:

	Options Issued	Weighted Average Exercise Price
Balance, February 3, 2006	20,258,324	$ 18.19
Granted	2,534,500	17.54
Exercised	(841,179)	13.00
Canceled	(463,849)	20.21
Balance, May 5, 2006	21,487,796	$ 18.27

During the 13-week periods ended May 5, 2006 and April 29, 2005, the weighted average grant date fair value of options granted was $5.89 and $6.56, respectively, 407,659 and 384,227 options vested, net of forfeitures, with a total fair value of approximately $1.5 million and $1.1 million, respectively, and the total intrinsic value of stock options exercised was $3.8 million and $7.5 million, respectively.

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At May 5, 2006, the aggregate intrinsic value of all outstanding options was $17.4 million with a weighted average remaining contractual term of 5.9 years, of which 18,599,096 of the outstanding options are currently exercisable with an aggregate intrinsic value of $17.4 million, a weighted average exercise price of $18.34 and a weighted average remaining contractual term of 5.3 years. At May 5, 2006, the total unrecognized compensation cost related to non-vested stock options was $15.4 million, which is expected to be recognized through March 2010 (the final vesting date for non-vested stock options currently outstanding), with an expected weighted average expense recognition period of 2.3 years.

All stock options granted in the 13-week periods ended May 5, 2006 and April 29, 2005 under the terms of the Company s stock incentive plan were non-qualified stock options issued at a price equal to the fair market value of the Company s common stock on the date of grant, were originally scheduled to vest ratably over a four-year period, and expire 10 years following the date of grant.

A summary of activity related to nonvested restricted stock and restricted stock unit awards during the 13-week period ended May 5, 2006 is as follows:

	Nonvested Shares	Weighted Average Grant Date Fair Value
Balance, February 3, 2006	363,687	$ 19.66
Granted	137,251	17.54
Vested	(56,908)	19.50
Canceled	(20,678)	19.42
Balance, May 5, 2006	423,352	$ 19.02

The purchase price was set at zero for all nonvested restricted stock and restricted stock unit awards in the 13-week period ended May 5, 2006. The Company is recording compensation expense on a straight-line basis over the restriction period based on the market price of the underlying stock on the date of grant. The nonvested restricted stock and restricted stock unit awards granted to employees during the 13-week period ended May 5, 2006 under the plan are scheduled to vest and become payable ratably over a three-year period from the respective grant dates.

The Company accounts for nonvested restricted stock and restricted stock unit awards in accordance with the provisions of SFAS 123(R). The Company calculates compensation expense as the difference between the market price of the underlying stock on the date of grant and the purchase price, if any, and recognizes such amount on a straight-line basis over the period in which the recipient earns the nonvested restricted stock and restricted stock unit award. Under the provisions of SFAS 123(R), unearned compensation is not recorded within shareholders equity, and accordingly, during the 13-week period ended May 5, 2006, the Company reversed its unearned compensation balance as of February 3, 2006 of approximately $5.2 million, with an offset to common stock and additional paid in capital. The Company recognized compensation expense relating to its nonvested restricted stock and restricted stock unit awards of approximately $0.8 million and $0.4 million in the 13-week periods ended May 5, 2006 and

April 29, 2005. At May 5, 2006, the total compensation cost related to nonvested restricted stock and restricted stock unit awards not yet recognized was $6.4 million.

There have been no modifications to any of the Company s outstanding share-based payment awards during the 13-week period ended May 5, 2006.

The Company has elected to determine its excess tax benefit pool upon adoption of SFAS 123(R) in accordance with the provisions of FASB Staff Position (FSP) 123(R)-3, Transition Election Related to Accounting for the Tax Effects of Share Based Payment Awards. Under the provisions of this FSP, the cumulative benefit of stock option exercises included in additional paid in capital for the periods after the effective date of SFAS 123 is reduced by the cumulative income tax effect of the pro-forma stock option expense previously disclosed in accordance with the requirements of SFAS 123. (The provision of this FSP applies only to options that are fully vested before the date of adoption of SFAS 123(R). The amount of any excess tax benefit for options that are either granted after the adoption of SFAS 123(R) or are partially vested on the date of adoption will be computed in accordance with the provisions of SFAS 123(R).) The amount of any excess deferred tax asset over the actual income tax benefit realized for options that are exercised after the adoption of SFAS 123(R) will be absorbed by the excess tax benefit pool. Income tax expense will be increased should the Company s excess tax benefit pool be insufficient to absorb any future deferred tax asset amounts in excess of the actual tax benefit realized. The Company has determined that its excess tax benefit pool is approximately $68 million as of the adoption of SFAS 123(R) on February 4, 2006.

3.

Earnings per share

Earnings per share is computed as follows (in thousands, except per share data):

	13 Weeks Ended May 5, 2006		
	Net Income	Shares	Per Share Amount
Basic earnings per share	$ 47,670	313,997	$ 0.15
Effect of dilutive stock awards		1,236	
Diluted earnings per share	$ 47,670	315,233	$ 0.15

	13 Weeks Ended April 29, 2005		
	Net Income	Shares	Per Share Amount
Basic earnings per share	$ 64,900	328,208	$ 0.20

Effect of dilutive stock awards			3,010		
Diluted earnings per share	$	64,900	331,218	$	0.20

Basic earnings per share was computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share was determined based on the dilutive effect of stock options and other common stock equivalents using the treasury stock method.

4.

Commitments and contingencies

Legal proceedings

On March 14, 2002, a complaint was filed in the United States District Court for the Northern District of Alabama (*Edith Brown, on behalf of herself and others similarly situated v. Dolgencorp, Inc., and Dollar General Corporation*, CV02-C-0673-W (*Brown*)). *Brown* is a collective action against the Company on behalf of current and former salaried store managers claiming that these individuals were entitled to overtime pay and should not have been classified as exempt employees under the Fair Labor Standards Act (FLSA). Plaintiffs seek to recover overtime pay, liquidated damages, declaratory relief and attorneys fees.

On January 12, 2004, the court certified an opt-in class of plaintiffs consisting of all persons employed by the Company as store managers at any time since March 14, 1999, who regularly worked more than 50 hours per week and either: (1) customarily supervised less than two employees at one time; (2) lacked authority to hire or discharge employees without supervisor approval; or (3) sometimes worked in non-managerial positions at stores other than the one he or she managed. The Company s request to appeal the certification decision on a discretionary basis to the 11th U.S. Circuit Court of Appeals was denied.

Notice was sent to prospective class members and the deadline for individuals to opt in to the lawsuit was May 31, 2004. Approximately 5,000 individuals opted in. Following the close of discovery in April 2005, the Company filed several motions, including a motion to decertify the class as a collective action. On March 31, 2006, the Court denied the Company s motion to decertify, but granted, either in whole or in part, certain other motions, thereby reducing the number of class members to approximately 2,500. Trial of this matter is scheduled to begin on July 31, 2006.

The outcome of any litigation is inherently uncertain. At trial, the Company bears the burden of establishing its entitlement to the exemption from the overtime requirements of the FLSA, and no assurances can be given that the Company will be successful. Prior rulings by the Court and limits the Court has imposed on the conduct of the trial, as well as future rulings by the Court on both substantive and procedural motions and issues, including evidentiary issues at trial, may significantly affect the course and outcome of these proceedings in a manner materially adverse to the Company s financial statements as a whole.

Three additional lawsuits, *Tina Depasquales v. Dollar General Corp.* (Southern District of Georgia, Savannah Division, CV 404-096, filed May 12, 2004), *Karen Buckley v. Dollar General Corp.* (Southern District of Ohio, C-2-04-484, filed June 8, 2004), and *Sheila Ann Hunsucker v. Dollar General Corp. et al.* (Western District of Oklahoma, Civ-04-165-R, filed February 19, 2004), were filed asserting essentially the same claims as the *Brown* case, and were subsequently consolidated in the Northern District of Alabama where the *Brown* litigation is pending. The plaintiffs in the *Depasquales* and the *Hunsucker* lawsuits have since dismissed their cases and opted into the *Brown* case. Following the *Buckley* plaintiff s abandonment of her federal FLSA claim, the Court dismissed her remaining state law claims without prejudice based on lack of subject matter jurisdiction.

On October 10, 2005, the Company was served with an additional lawsuit, *Moldoon, et al. v. Dolgencorp, Inc., et al.* (Western District of Louisiana, Lake Charles Division, CV05-0852, filed May 19, 2005), filed as a putative collective action in which five current or former store managers claim to have been improperly classified as exempt executive employees under the FLSA. Plaintiffs seek injunctive relief, back wages, liquidated damages and attorneys fees. Although the Company has answered the *Moldoon* complaint, discovery has not yet begun. On April 26, 2006, this action was conditionally transferred to the Northern District of Alabama and consolidated with the *Brown* case. The Company intends to oppose the transfer and consolidation of this matter. At this time, it is not possible to predict whether the Court will permit this action to proceed collectively or whether the action ultimately will be consolidated with the *Brown* litigation.

The Company believes that its store managers are and have been properly classified as exempt employees under the FLSA and that the actions described above are not appropriate for collective action treatment. The Company intends to vigorously defend these actions. However, no assurances can be given that the Company will be successful in that defense on the merits or otherwise, and, if it is not, the resolution or resolutions could have a material adverse effect on the Company s financial statements as a whole.

On May 18, 2006, the Company was served with a lawsuit entitled *Tammy Brickey, Becky Norman, Rose Rochow, Sandra Cogswell and Melinda Sappington v. Dolgencorp, Inc. and Dollar General Corporation* (Western District of New York, Case 6:06-cv-06084-DGL, originally filed on February 9, 2006 and amended on May 12, 2006 (*Brickey*)). The *Brickey* plaintiffs seek to proceed collectively under the FLSA and as a class under New York, Ohio, Maryland and North Carolina wage and hour statutes on behalf of, among others, individuals employed by the Company as Assistant Store Managers who claim to be owed wages (including overtime wages) under those statutes. At this time, it is not possible to predict whether the court will permit this action to proceed collectively or as a class. However, the Company believes that this action is not appropriate for either collective or class treatment, and believes that its wage and hour policies and practices comply with both federal and state law. The Company plans to vigorously defend this action; however, no assurances can be given that the Company will be successful in its defense on the merits or otherwise, and, if it is not, the resolution of this action could have a material adverse effect on the Company s financial statements as a whole.

On March 7, 2006, a complaint was filed in the United States District Court for the Northern District of Alabama (*Janet Calvert v. Dolgencorp, Inc.*, Case 2:06-cv-00465-VEH) *(Calvert),* in which the plaintiff, a former Store Manager, alleged that she was paid less than male Store Managers because of her sex, in violation of the Equal Pay Act (EPA) and Title VII of the Civil Rights Act of 1964, as amended (Title VII). On March 9, 2006, the *Calvert* complaint was amended to include seven additional plaintiffs, who also allege to have been paid less than males because of their sex, and to add allegations of sex discrimination in promotional opportunities and undefined terms and conditions of employment. In addition to allegations of intentional sex discrimination, the amended *Calvert* complaint also alleges that the Company s employment policies and practices have a disparate impact on females. The amended *Calvert* complaint seeks to proceed collectively under the EPA and as a class under Title VII, and

requests back wages, injunctive and declaratory relief, liquidated damages and attorney s fees and costs.

The Company has filed its Answer to the *Calvert* amended complaint, but discovery has not yet begun. At this time, it is not possible to predict whether the Court will permit this action to proceed collectively or as a class. However, the Company believes that this case is not appropriate for either collective or class treatment, and believes that its policies and practices comply with the EPA and Title VII. Although the Company intends to vigorously defend this action, no assurances can be given that the Company will be successful in its defense on the merits or otherwise, and if it is not, the resolution of this action could have a material adverse effect on the Company s financial statements as a whole.

On April 28, 2006, the Company was served with an additional lawsuit, *Linda Beeman, on behalf of herself and all others similarly situated, v. Dolgencorp, Inc. d/b/a Dollar General*, 06-CV-0250 (*Beeman*), filed on February 28, 2006 in the United States District Court for the Northern District of New York, in which the plaintiff, a former store manager, raises claims substantially similar to those raised in the *Calvert* matter. Specifically, the plaintiff in *Beeman* alleges that she was paid less than similarly situated male store managers, denied promotional opportunities and treated less favorably with respect to other, undefined terms and conditions of employment because of her sex in violation of the EPA and Title VII. The *Beeman* plaintiff seeks to proceed collectively under the EPA and as a class under Title VII, and requests back wages, injunctive and declaratory relief, liquidated damages and attorney s fees and costs. Because the *Beeman* plaintiff asserts essentially the same claims for essentially the same putative class as the *Calvert* matter, the Company believes that the *Beeman* filing does not materially increase the exposure that the Company potentially faces as a result of the claims in *Calvert*.

The Company has filed its Answer to the *Beeman* complaint. At this time, it is not possible to predict whether the Court will permit this action to proceed collectively or as a class. However, as with the *Calvert* action, the Company believes that this case is not appropriate for class or collective treatment, and believes that its policies and practices comply with the EPA and Title VII. The Company intends to vigorously defend this action; however, no assurances can be given that the Company will be successful in its defense on the merits or otherwise. If the Company is not successful in defending this action, its resolution could have a material adverse effect on the Company s financial statements as a whole.

In addition to the matters described above, the Company is involved in other legal actions and claims arising in the ordinary course of business. The Company believes, based upon information currently available, that such other litigation and claims, both individually and in the aggregate, will be resolved without a material effect on the Company s financial statements as a whole. However, litigation involves an element of uncertainty. Future developments could cause these actions or claims to have a material adverse effect on the Company s financial statements as a whole.

5.

Income taxes

The effective income tax rates for the 13-week periods ended May 5, 2006 and April 29, 2005 were 37.7% and 37.3%, respectively. The increase consisted of an approximate 0.5% increase in the effective income tax rate as a result of the December 31, 2005 expiration of the federal laws which allow the Company to claim certain federal jobs credits for employees hired after that date, partially offset by an approximate 0.1% increase in state job related tax credits due principally to jobs added at the Company s South Carolina distribution center.

6.

Repurchases of common stock

On September 30, 2005, the Board of Directors authorized a repurchase program for up to 10 million shares of the Company s outstanding common stock, which was scheduled to expire on September 30, 2006. During the 13-week period ended May 5, 2006, the Company purchased approximately 4.5 million shares at a cost of $79.9 million, thereby completing this share repurchase authorization.

7.

Segment reporting

The Company manages its business on the basis of one reportable segment. As of May 5, 2006, all of the Company s operations were located within the United States, with the exception of a Hong Kong subsidiary, the assets and revenues of which are not material. The following data is presented in accordance with SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information.

	13 Weeks Ended	
(In thousands)	May 5, 2006	April 29, 2005
Classes of similar products:		
Highly consumable	$ 1,455,984	$ 1,321,306
Seasonal	309,583	275,295
Home products	211,665	211,752