2015
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# 2015 BDO RETAIL RISKFACTOR REPORT

## WEAK START TO 2015 AFFIRMS RETAILERS' CONCERNS OVER STRATEGIC GROWTH

The ***2015 BDO Retail RiskFactor Report*** examines the risk factors in the most recent 10-K filings of the largest 100 publicly traded U.S. retailers; the factors are analyzed and ranked by order of frequency cited.

Following a lackluster start to 2015 for many retailers, widespread concerns remain among the industry's top players about how to invest for growth in the U.S. marketplace, according to the ***2015 BDO Retail RiskFactor Report***. Two mainstays of the post-recession retail landscape – intense competition and consolidation – are still entrenched across the industry, prompting retailers to strategically vie for opportunities to expand their brands and provide their customers with speed, convenience and unique products.

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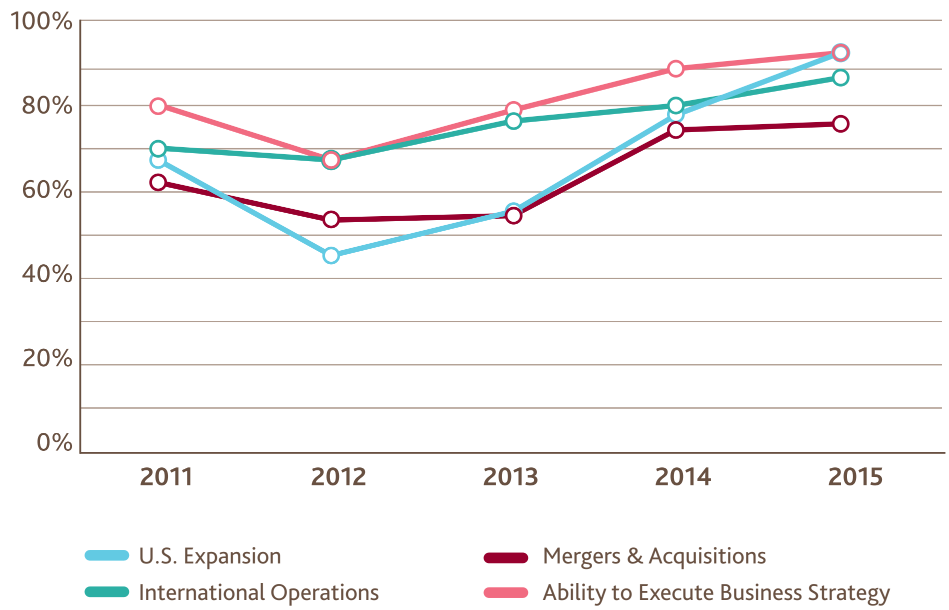
So far, 2015 has offered little reassurance for retailers looking to minimize exposures around their strategic growth initiatives, with a mixed bag of economic signals and performance indicators keeping them guessing during the first half of the year. Consumer confidence soared to pre-recession levels in January, and although it wavered slightly this spring, has maintained high marks. But despite promising confidence levels, an improving U.S. job market and a host of other positively trending economic factors, consumers remain cautious, and flat spending levels have stymied sales growth throughout the first two quarters.

As they find footing in this uncertain landscape, 92 percent of retailers note risks related to U.S. growth and expansion, up from 78 percent in 2014 and 56 percent in 2013. More of these companies are looking at consolidation as a way to achieve growth through boosting market share and geographic coverage, with 76 percent citing merger and acquisition risks. Meanwhile, solid 2014 growth left some retailers with stronger cash flows this year, affording them the opportunity to invest in their products, online sales platforms and customer experience. But this strategy carries its own pitfalls, with 92 percent citing a failure to execute as a risk. Another 71 percent cite failure to successfully invest capital and prove ROI as a threat.

From e-commerce growth and cybersecurity to workforce dynamics and supply chain disruptions, the industry teems with uncertainties. In an environment rife with competitive threats, disruptive transformation and regulatory pressures, retailers now face the intensified challenge of pursuing strategic growth while minimizing their downsides.

**Strategic Growth Risks Continue to Climb**




## IT SYSTEM RISKS GROW MORE PREVALENT

Retail CFOs expect nearly double digit online sales growth this year, according to BDO's ***2015 Retail Compass Survey of CFOs***, and virtually all (99 percent) retailers now cite both IT systems operations and cybersecurity threats as top risks, a stark contrast to 2007, when only 26 percent flagged cybersecurity issues in their 10-K filings.

The reasons for this evolution are clear. Although IBM calculated that the number of cyber breaches against retailers actually declined in 2014, the high legal, operational and reputational costs associated with point-of-sale intrusions and web application attacks still have retailers worried, especially as they expand their digital offerings and become increasingly cloud-based.

Similarly, the rising popularity of Apple Pay and other mobile payment technologies – paired with new regulations requiring secure EMV-enabled chip card processors – has placed new pressure on retailers to correctly implement new systems. Along with implementation costs, it's also important that retailers make the necessary investments to keep these new technologies secure to minimize their potential liability for credit card fraud and mitigate a host of external threats.

"Up until 2008, when consumer confidence and sales increased, retailers' default avenue for growth was to invest cash in new stores," said **Doug Hart, partner in BDO's Consumer Business practice**. "But the paradigm has shifted. Now, with economic and industry conditions slowly improving and aligning, retailers are pursuing more dynamic investments in hopes of breaking through the noise and improving profitability. From expanding digital sales channels and acquiring technologies, to reengineering their supply chain networks, these capital-intensive growth strategies often come with higher risks, but they are critical to surviving in today's competitive market."

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A majority (56 percent) of retailers are proactively investing more in their cybersecurity measures this year, according to results from the ***2015 Retail Compass Survey of CFOs.*** Among those retailers, 89 percent had begun using new software tools and 81 percent have created a security breach response plan. Meanwhile, 40 percent had hired an external security consultant and 11 percent had brought in a Chief Security Officer. Still, heightened concerns over legal proceedings (95 percent) point to the far-reaching and costly damage IT failures can bring to consumer businesses.

## TIGHTENING WORKFORCE BOOSTS LABOR MARKET CONCERNS

Labor risks remain top of mind for a full 96 percent of retailers. With strong overall job growth so far in 2015, retailers are facing an increasingly competitive labor environment, and are struggling to hire and retain qualified store associates and distribution center employees. Retail behemoths like Wal-Mart and Target have begun to offer more benefits and higher wages in an effort to attract and keep the best workers. This approach, however, is not without its risks: Sixty-three percent of retailers are concerned about the growing cost of healthcare for their employees as a result of the ACA and other labor regulations. At the same time, many fast food chains are responding to external pressures – including union and employee protests – that are pushing for higher hourly wages. As wage hikes become more widely adopted, retailers will increasingly be reevaluating their compensation and incentive offerings.

Competition for top industry executives also remains cutthroat. On the hunt for dynamic leaders that understand both the industry and its digital evolution, four-in-five retailers cite risks related to attracting and retaining key management personnel.

| Top 20 Risks for Retailers | 2015 | | 2014 | | 2013 | | 2012 | |
|---|---|---|---|---|---|---|---|---|
| General Economic Conditions | #1 | 100% | #1 | 100% | #1 | 100% | #1 | 99% |
| Federal, State and/or Local Regulations | #1t | 100% | #2 | 99% | #2 | 97% | #4 | 85% |
| Competition and Consolidation in Retail Sector | #1t | 100% | #3 | 98% | #4 | 94% | #3 | 94% |
| Implementation and Maintenance of IT Systems | #4 | 99% | #7 | 92% | #5 | 89% | #6t | 83% |
| Privacy Concerns Related to Security Breach | #4t | 99% | #8t | 91% | #8 | 85% | #12 | 72% |
| U.S. and Foreign Supplier/Vendor Concerns | #6 | 98% | #4 | 96% | #3 | 95% | #2 | 97% |
| Labor (health coverage, union concerns, staffing) | #7 | 96% | #5 | 94% | #6 | 86% | #10 | 78% |
| Natural Disasters, Terrorism and Geopolitical Events | #7t | 96% | #13 | 87% | #11 | 83% | #5 | 84% |
| Dependency on Consumer Trends | #9 | 95% | #6 | 93% | #8t | 85% | #6 | 83% |
| Legal Proceedings | #9t | 95% | #8t | 91% | #13 | 78% | #11 | 73% |
| Credit Markets/Availability of Financing and Company Indebtedness | #11 | 94% | #11t | 89% | #6t | 86% | #8 | 82% |
| Failure to Properly Execute Business Strategy | #12 | 92% | #11t | 89% | #12 | 79% | #13 | 68% |
| Impediments to Further U.S. Expansion and Growth | #12t | 92% | #17 | 78% | #20 | 56% | #20t | 46% |
| Changes to Accounting Standards and Regulations | #14 | 90% | #13t | 87% | #15 | 69% | #17 | 58% |
| Consumer Confidence and Spending | #15 | 89% | #8t | 91% | #10 | 84% | #9 | 81% |
| Goodwill Impairment | #16 | 88% | #19t | 71% | #28 | 37% | #25t | 39% |
| International Operations | #17 | 86% | #15 | 80% | #14 | 76% | #13t | 68% |
| Environmental Laws, Regulations & Liability | #18 | 83% | #19t | 71% | #19 | 57% | #22 | 42% |
| Loss of Key Management/New Management | #19 | 80% | #16 | 79% | #16 | 68% | #15 | 63% |
| Insurance Costs and Uninsured Liabilities | #20 | 77% | #22 | 66% | #17 | 63% | #20 | 46% |

*t indicates a tie in the risk factor ranking

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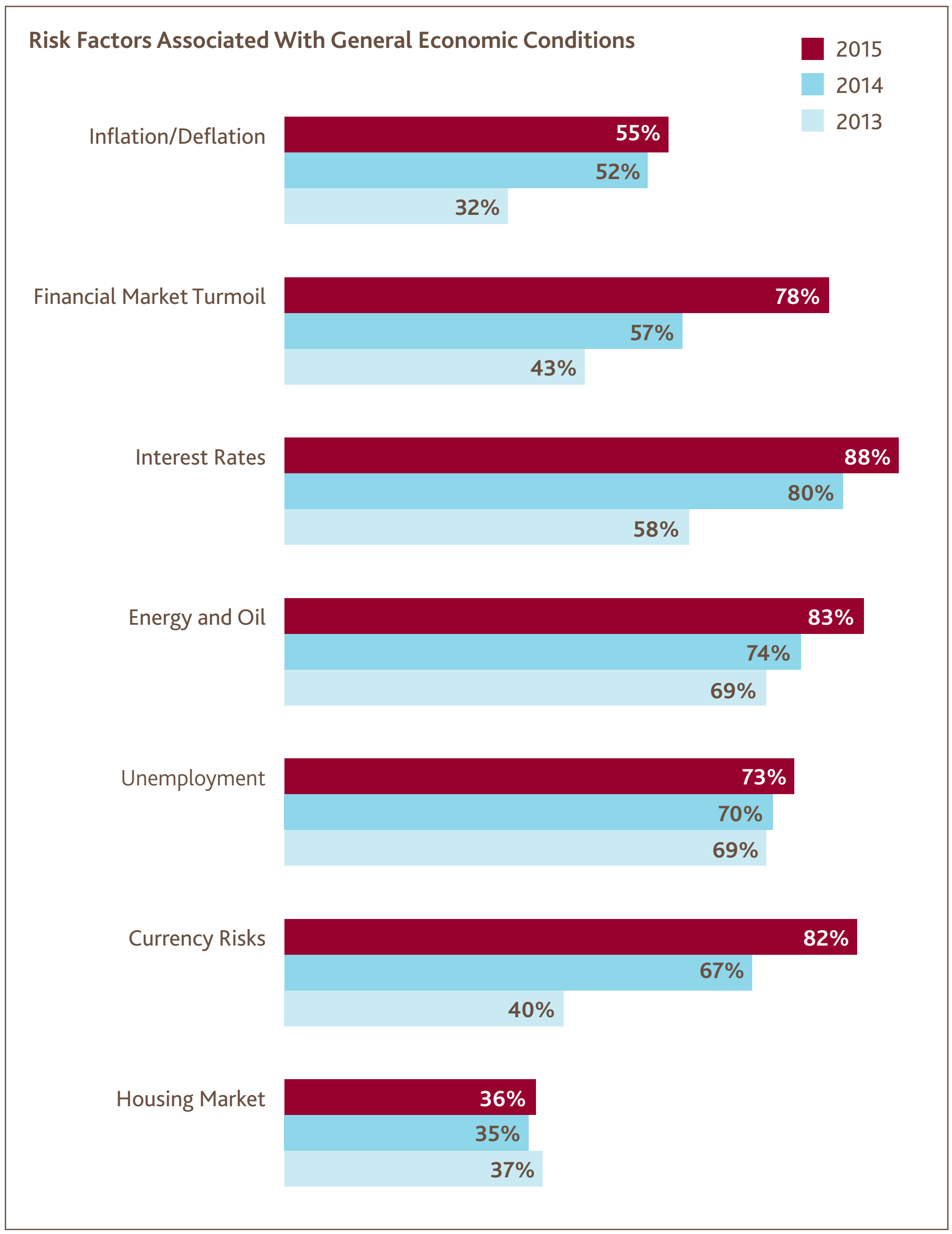
## INTEREST RATES AND FUEL PRICES TAKE TOP SPOTS ON ECONOMIC RISK LIST

Along with top industry risks, the ***BDO Retail RiskFactor Report*** looks at specific challenges retailers cite under general economic conditions. For the second year in a row, interest rates (88 percent) came in as the most frequently mentioned concern. At this point, unemployment has trended below 6 percent since September 2014, according to the Bureau of Labor Statistics. Now, both retailers and consumers alike are fixated on the Federal Reserve, questioning whether it will soon curtail its easy-money policy and raise what have been historically low interest rates over the past several years. If it does normalize rates, companies are well aware of the potential negative impact on consumer spending, as well as debt financing and credit access, which 94 percent specifically cite as a risk this year.

Meanwhile, retailers' energy and fuel price concerns also remain high, cited by 83 percent of retailers analyzed. With some analysts forecasting an imminent rise in what have been depressed gasoline prices since last fall, retailers are sensitive to the impact of price hikes on their own transportation costs, as well as their effect on consumer sentiment and buying power. A fuel price increase could have a particularly pronounced effect on the consumer side at this point, as tepid overall spending indicates that consumers have opted to either save the money they aren't paying at the pump or use it to pay down debt.

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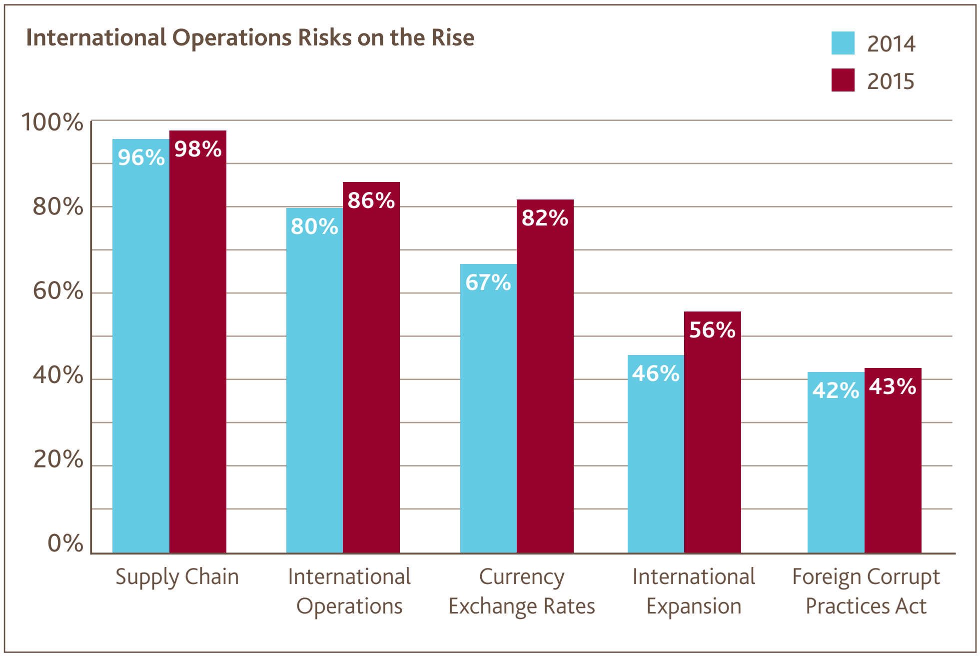
## SUPPLY CHAIN AND CURRENCY CONCERNS HAVE RETAILERS MULLING INTERNATIONAL OPERATIONS

As retailers vie for domestic growth, international risks remain on their radars. In fact, nearly nine-in-10 companies cite international operations risks, including economic conditions, laws and regulations, this year. More notably, virtually all (98 percent) retailers are worried about supplier and vendor risks, including shipping and imports. The precarious sourcing situation that resulted from labor negotiations at U.S. West Coast ports undoubtedly opened many retailers' eyes to their distribution and inventory exposures. Although the labor issues were resolved in February, delays and price hikes took a toll this spring, prompting more retailers to consider near-sourcing as a strategic approach to lowering costs and liabilities. In fact, North America overtook Asia as the most attractive sourcing region this year, according to results from our ***2015 Retail Compass Survey of CFOs***.

With the U.S. dollar's value having risen 22 percent on the ICE dollar index year-over-year as of late April, currency rate risks and their impact on profits and revenues are also of chief concern for 82 percent of retailers. Converting foreign sales to U.S. dollars in this environment, especially for retailers with stores in European and BRIC countries, can cut deeply into margins, as can sourcing internationally in U.S. dollars.




Along with sourcing and exchange rate challenges, retailers also continue to monitor their compliance with international regulations and ensuing liabilities. With more cross-border activity occurring than ever before, retailers with decentralized international operations are increasingly realizing the need for more robust investment and board involvement in order to establish effective compliance programs. In line with last year's results, 43 percent of retailers highlight risks surrounding the Foreign Corrupt Practices Act in their 10-Ks, up from 27 percent in 2013.

Above all, the year ahead will challenge and reward those retailers whose leaders carefully pursue innovative growth initiatives and nimble investment strategies. As retailers hold out hope that consumer spending will soon align with the more promising conditions in the broader market, the ***2015 Retail RiskFactor Report*** indicates that they are well aware of their own exposures to the most pressing economic, regulatory and competitive threats. Looking ahead, sustainable growth demands the right balance of caution and aggression in order for retailers to mitigate their downside risks and stay out in front of their competition.

"Anti-corruption and fraud risk is an industry-agnostic business issue. However, as retailers continue to scale globally through online sales platforms and other growth initiatives, they will face a greater need to design and implement robust anti-corruption internal controls and compliance programs to better detect violations and ensure compliance with U.S. regulations, such as the FCPA, as well as country-specific laws," said **Nina Gross, managing director at BDO Consulting and a leader within the firm's Global Forensics Practice**.

## ABOUT THE CONSUMER BUSINESS PRACTICE AT BDO USA, LLP

BDO has been a valued business advisor to consumer business companies for 100 years. The firm works with a wide variety of clients across the sector, ranging from multinational Fortune 500 corporations to more entrepreneurial businesses, on myriad accounting, tax and other financial issues.

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