2014 BDO RETAIL RISKFACTOR REPORT

PROMISING SIGNS OF GROWTH SURFACE NEW RISKS FOR RETAILERS

The ***2014 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.

The retail industry saw sluggish gains in 2013, but modest growth and a healthy start to 2014 have been hopeful signs of progress in the year ahead. Still, opportunities for growth bring unique risks, and retailers have their ear to the ground as they anticipate the pitfalls associated with their strategic initiatives and the ongoing possibility of a future economic slowdown. With increasing industry competition, uncertainties around new and potential regulations and the growing need to expand and secure IT systems, retailers will rely heavily upon their executive teams as they look to capitalize on new opportunities, while at the same time reducing their exposure within a rapidly transforming industry.

Read more

For more information on BDO USA's service offerings to this industry, please contact one of the following practice leaders:

AL FERRARA, New York
212-885-8000 / aferrara@bdo.com

DAVID BERLINER, New York
212-885-8347 / dberliner@bdo.com

RANDY FRISCHER, New York
212-885-8445 / rfrischer@bdo.com

DOUGLAS HART, San Francisco
415-490-3314 / dhart@bdo.com

NATALIE KOTLYAR, New York
212-885-8035 / nkotlyar@bdo.com

ISSY KOTTON, Los Angeles
310-557-0300 / ikotton@bdo.com

RICK SCHREIBER, Memphis
901-680-7607 / rschreiber@bdo.com

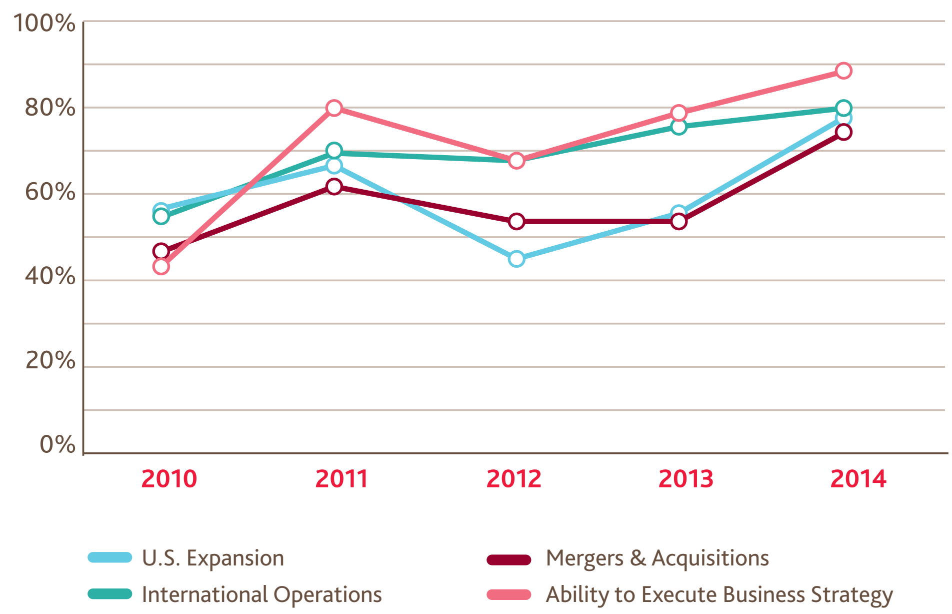
ALAN SELLITTI, New York
212-885-8599 / asellitti@bdo.com

TED VAUGHAN, Dallas
214-665-0752 / tvaughan@bdo.com

Consumer confidence hit its highest mark since 2008 in March, according to the Conference Board Index, and with the U.S. economy on firmer footing, retailers have renewed their focus on domestic growth. Our analysis of the risk factors listed in the most recent 10-K filings of the largest 100 public U.S. retailers found that a full 98 percent of companies consider strong competition and consolidation within the industry a top risk. As they deliberate on how best to navigate this competitive landscape, 78 percent of retailers cite risks associated with U.S. growth, up from 56 percent in 2013. Meanwhile, as companies jockey for greater revenue, increased market share and more robust distribution channels, concerns around mergers and acquisitions are top of mind for 74 percent of retailers, up from 54 percent last year.

Successful growth strategies in 2014 will depend upon retailers' ability to compete in the digital landscape. Goldman Sachs estimates that global e-commerce will accelerate in the year ahead, and consumers have increasingly demanded robust omnichannel offerings that are nimble, integrated and secure. To capitalize on this expected digital growth, many retailers are investing in new technologies to bolster their online services. These initiatives are inherently risky, however, and the number of companies citing concerns over their e-commerce initiatives rose from 28 percent in 2013 to 50 percent this year. At the same time, failure to properly execute such business strategies is a growing worry: Nearly nine-in-ten retailers note it as a risk this year. To hedge this risk, companies will rely heavily upon both the industry acumen and digital savvy of their top leaders to navigate them through the sector's many transformations.

Risks Related to Strategic Growth Initiatives Increase



CYBERSECURITY CONCERNS BECOME UNIVERSAL

Several recent, costly and high-profile cyber breaches at major retailers like Target and Neiman Marcus have shone a public spotlight on the security of retailers' IT systems, and as a result, companies' concerns are at an all-time high. This year, 92 percent cite risks related to the implementation of IT systems and technology. Meanwhile, nine-in-ten retailers now note concerns over data security, nearly double the amount that did in 2009, and with good reason: According to Verizon, there were 467 security incidents in the retail industry in 2013, with point-of-sale intrusion and Web application attacks being the most common types of threat.

In response to these developments, retailers are moving to reinforce their protection: Our ***2014 Retail Compass Survey of CFOs*** found that 27 percent of U.S. retailers will be investing the most capital into their IT systems and technology during the year ahead. Broader industry support is also on the rise. The NRF established a new Cyber Security Platform designed to provide real-time information on threats, and several major retailers, including Gap, Nike, Walgreens and Lowe's launched the Retail Cyber Intelligence Sharing Center to share and analyze data in order to stay ahead of future threats.

"Cyber threats are becoming more prevalent and sophisticated every day, forcing retailers to reevaluate their vulnerabilities to ensure they have the requisite technologies and response protocols in place to mitigate this growing risk, especially when it comes to their point-of-sale systems," said **Karen Schuler, Managing Director at BDO Consulting, leading the firm's Forensic Technology Services Practice in Washington, D.C.** "In order to secure customers' personally identifiable information and credit card data, it is essential that companies maintain and update proper IT controls. Having the right systems in place allows companies to guard against attacks and respond quickly and effectively if and when a breach does occur."

▶ Read more

Top 20 Risks for Retailers	2014		2013		2012		2011	
General Economic Conditions	#1	100%	#1	100%	#1	99%	#1	97%
Federal, State and/or Local Regulations	#2	99%	#2	97%	#4	85%	#4	92%
Competition & Consolidation in Retail Sector	#3	98%	#4	94%	#3	94%	#2	95%
U.S. and Foreign Supplier/Vendor Concerns	#4	96%	#3	95%	#2	97%	#2t	95%
Labor (health coverage, union concerns, staffing)	#5	94%	#6	86%	#10	78%	#7	84%
Dependency on Consumer Trends	#6	93%	#8t	85%	#6	83%	#5	87%
Implementation & Maintenance of IT Systems	#7	92%	#5	89%	#6t	83%	#12	73%
Privacy Concerns Related to Security Breach	#8	91%	#8	85%	#12	72%	#19	55%
Consumer Confidence and Spending	#8t	91%	#10	84%	#9	81%	#11	77%
Legal Proceedings	#8t	91%	#13	78%	#11	73%	#7t	84%
Credit Markets/Availability of Financing and Company Indebtedness	#11	89%	#6t	86%	#8	82%	#6	86%
Failure to Properly Execute Business Strategy	#11t	89%	#12	79%	#13	68%	#10	80%
Natural Disasters, Terrorism and Geo-Political Events	#13	87%	#11	83%	#5	84%	#9	83%
Changes to Accounting Standards and Regulations	#13t	87%	#15	69%	#17	58%	#14	72%
International Operations	#15	80%	#14	76%	#13t	68%	#15	70%
Loss of Key Management/New Management	#16	79%	#16	68%	#15	63%	#12t	73%
Impediments to Further U.S. Expansion and Growth	#17	78%	#20	56%	#20t	46%	#16	67%
Mergers & Acquisitions	#18	74%	#21	54%	#18	54%	#18	62%
Environmental Laws, Regulations & Liability	#19	71%	#19	57%	#22	42%	#26	43%
Impairment of Goodwill	#19t	71%	#28	37%	#25t	39%	N/R	N/R

*t indicates a tie in the risk factor ranking

▶WORKFORCE CHALLENGES GROW AMID COMPETITION AND NEW REGULATION

The retail industry remains the largest private employer in the U.S., and this year, 94 percent of retailers cite risks related to labor, up from 86 percent in 2013. With the Affordable Care Act now in full swing and wages expected to continue their rise, retailers are determining how to balance the extension of benefits to qualifying employees and the absorption of the increased costs of labor. The number of retailers noting healthcare and benefit costs as a risk has nearly tripled in the past two years, from 20 percent in 2012 to 57 percent in 2014. At the same time, unemployment has fallen to 6.3 percent—its lowest since September 2008—and an improving job market translates into greater competition as retailers vie for the most qualified workers in a shrinking pool of applicants.

Meanwhile, concerns persist when it comes to adequately filling the corner office, as 79 percent of retailers cite attracting and retaining key personnel as a risk, an increase of 11 percentage points compared to 2013. Facing intense competition from online retailers and a rapidly transforming digital landscape, executives must be nimble and versatile in order to successfully navigate their companies through industry shifts. With many retailers, including Target, J.C. Penney and American Eagle, struggling to fill key roles following turnover at the top, it appears that the search for leaders with industry acumen and digital savvy will continue to prove difficult until more successful models emerge.

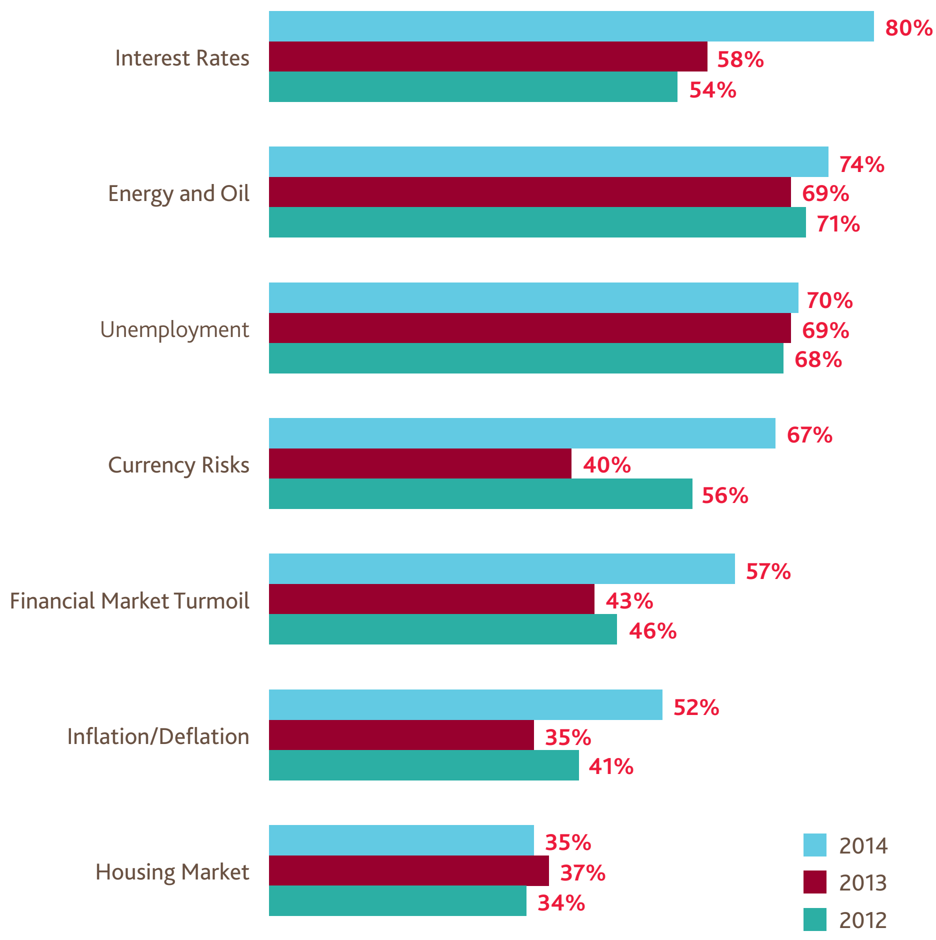
▶Read more

"Higher interest rates are a double-edged sword for retailers," **Doug Hart, partner in BDO's Retail and Consumer Products practice**, told the *Wall Street Journal*. "For one, higher rates translate to higher mortgage costs and student loan payments, things that could hurt consumer spending. It also increases retailers' borrowing costs. Most retailers rely on some form of debt financing."

▶INTEREST RATES OVERTAKE FUEL PRICES AND UNEMPLOYMENT AS TOP ECONOMIC RISK

In addition to top industry risks, the study also analyzes specific challenges retailers cite pertaining to general economic conditions. This year marked the first time in which interest rates (80 percent) are more frequently cited as an economic risk than fuel prices (74 percent) and unemployment (70 percent). After five years of historically low interest rates, concerns remain about whether or not the Fed will adhere to its plans for gradually tapering asset purchases and how the improving employment picture will impact interest rates moving forward. Higher rates could potentially stymie the slow but steady growth in consumer spending and sales, and retailers remain mindful about their own ability to finance debt, pension plan assets and new investments if higher rates become the new norm.

Risk Factors Associated With General Economic Conditions



▶ONGOING DEBATE, NEW STANDARDS KEEP REGULATORY CONCERNS FRONT AND CENTER

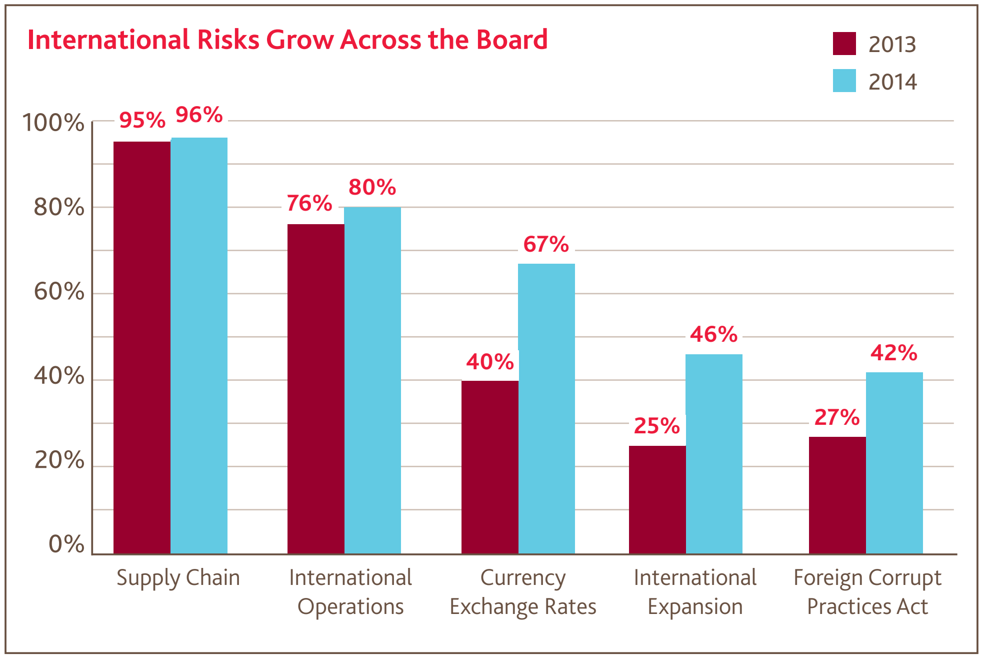
For a resounding 99 percent of retailers, changes in federal, state and local regulations remain top of mind this year amidst ongoing debate about minimum wage and the privacy of consumer data. As the White House continues to press Congress to increase the federal minimum wage to $10.10, union organizers and employees throughout the country continue to stage protests. Meanwhile, Wal-Mart, the largest retailer in the U.S. with 1.3 million U.S. employees, announced that it would not contest the proposed increase.

At the same time, as regulators increase scrutiny on internal controls, 87 percent of retailers cite concerns related to accounting standards and regulations, a significant jump from 2013 (69 percent) and the most in the report's history. Much of this pressure is due to a renewed focus by companies, auditors and regulators on internal controls, including the new COSO internal control framework published in 2013. Additionally, retailers are faced with a number of lingering tax uncertainties: Questions remain about the full scope of sales tax nexus laws for online retailers, and several favorable provisions expired at the end of 2013, including the bonus depreciation tax break. As Washington continues to debate the tax code as a whole, it remains to be seen how the retail sector's tax liabilities may be affected.

▶Read more

ROADBLOCKS AND REGULATIONS BOOST CONCERNS OVER INTERNATIONAL OPERATIONS AND SUPPLY CHAIN RISKS

With domestic sales growth and consumer confidence on the rise, retailers remain cognizant of increasing risks associated with international growth. Eighty percent of retailers note concerns over international operations, and the number citing risks associated with global expansion rose from 25 percent in 2013 to 46 percent this year. While a number of apparel retailers such as Gap, J. Crew and Ralph Lauren continue to aggressively search out opportunities to expand their brands overseas, other companies have encountered significant hurdles after pushing into foreign markets. Among them, Wal-Mart's move into China and Target's venture into Canada were met with difficulties surrounding pricing concerns, intense local competition and effectively scaling inventory.



International operations also increase supply chain risks, which ranked fourth overall this year with 96 percent of retailers citing concerns over suppliers, vendors, imports, regulatory compliance and product availability and costs. Retailers also note concern over commodity costs and exposure to volatile foreign currency exchange rates.

At the same time, international regulatory concerns are also widespread. This year, 42 percent of retailers point to risks associated with the Foreign Corrupt Practices Act, up from 27 percent last year, indicating that companies are faced with increasing costs and uncertainties as they establish compliance programs and gauge their exposure to liabilities overseas.

PERCEIVED EXPOSURE TO LITIGATION HITS ALL-TIME HIGH

Since 2007, retailers have become considerably more concerned about incurring damages—both financial and reputational—from legal proceedings. This year, 91 percent of retailers cite this risk, up from 78 percent in 2013 and 33 percent in 2007. Several factors likely underlie this uptick: While standard concerns regarding intellectual property infringement, product liability and wage discrimination persist, the current spotlight on cybersecurity threats is adding to retailers' worries concerning the legal ramifications of failing to protect their customers' data. Aside from the financial consequences, retailers are increasingly sensitive to reputational harm brought on by high-profile legal proceedings. The number of retailers citing impairment of goodwill or intangible assets nearly doubled year-over-year, from 37 percent in 2013 to 71 percent this year.

Overall, the 2014 Retail RiskFactor Report indicates that threats related to strategic growth initiatives are top of mind for retailers as they look to take advantage of more favorable economic conditions and pull ahead amid intense competition. Along with modest growth in the industry during Q1, there is tempered optimism for more robust and sustainable gains in sales throughout the months ahead, and companies understand that with this opportunity for growth comes risk. For retailers to mitigate both their long-term and short-term exposure, they should consider strategies that allow them to navigate the complex technological, regulatory and economic trends that are currently reshaping the industry.

ABOUT THE RETAIL AND CONSUMER PRODUCTS PRACTICE AT BDO USA, LLP

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

ABOUT BDO

BDO is the brand name for BDO USA, LLP, a U.S. professional services firm providing assurance, tax, financial advisory and consulting services to a wide range of publicly traded and privately held companies. For more than 100 years, BDO has provided quality service through the active involvement of experienced and committed professionals. The firm serves clients through 49 offices and more than 400 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multi-national clients through a global network of 1,264 offices in 144 countries.

BDO USA, LLP, a Delaware limited liability partnership, is the U.S. member of BDO International Limited, a UK company limited by guarantee, and forms part of the international BDO network of independent member firms. BDO is the brand name for the BDO network and for each of the BDO Member Firms.