2013 BDO RETAIL RISKFACTOR REPORT

REGULATORY CONCERNS PROLIFERATE FOR RETAILERS IN 2013

The ***2013 BDO RiskFactor Report for Retail Businesses*** 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.

After a shaky 2012 marked by both highs and lows for the industry, retailers are keeping a careful eye on the factors that may undermine their stability in 2013. A shifting regulatory landscape at home and abroad, combined with rising labor costs and the growing risk of external threats to IT systems and supply chains, ranks among retailers' top risks as they work to navigate an industry in flux.

Retailers are feeling particular pressure from a heightened regulatory climate. Our analysis of the risk factors listed in the most recent 10-K filings of the largest 100 public U.S. retailers found that federal, state and local regulations have increased as a risk among the nation's largest retailers. Nearly all retailers (97 percent) cite regulations as a risk as they navigate real and potential changes to their business, such as increasing employee healthcare costs and consumer spending. The risk was cited by the most retailers in the study's seven-year history and was second only to general economic conditions (100 percent).

Underlying this year's growing concern over the regulatory environment is renewed attention on potential changes to taxes,

▶ Read more

CONTACT:

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

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

STEVE FERRARA
Chicago
312-616-4683 / sferrara@bdo.com

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

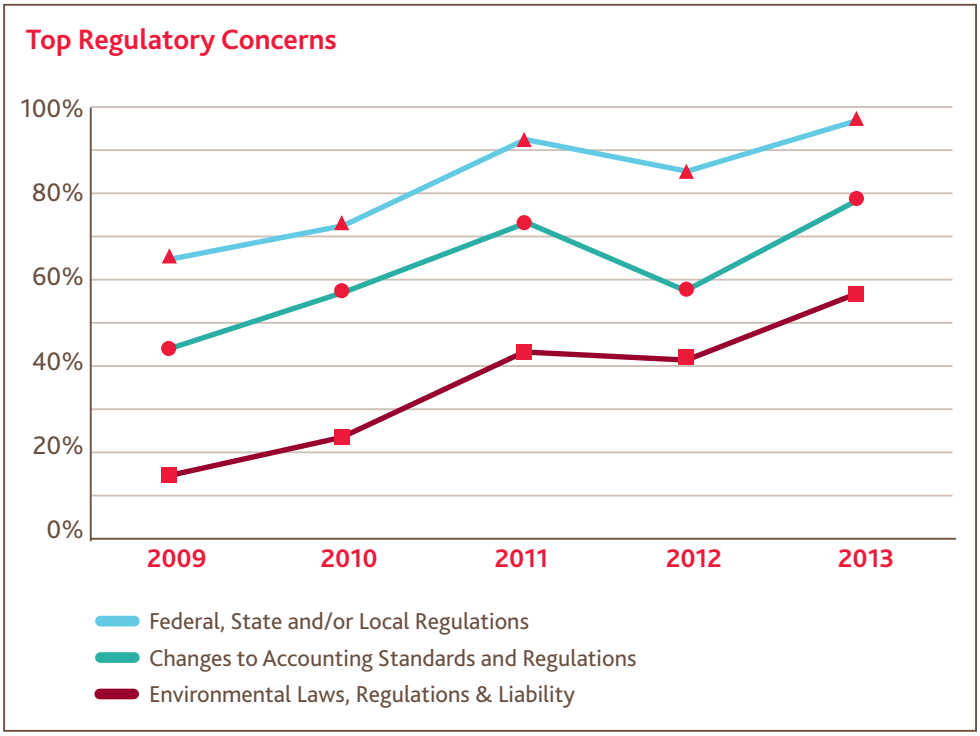
DOUGLAS HART
San Francisco
415-490-3314 / dhart@bdo.com

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

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

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

both corporate and individual. In January, lawmakers narrowly averted the fiscal cliff by cutting a deal to end the payroll tax holiday consumers had been enjoying since 2010, and high-income shoppers faced their first tax hike in two decades. At the same time, the internet sales tax debate rages on as lawmakers weigh in on the costs and benefits of taxing online purchases. Brick-and-mortar retailers generally support an internet sales tax, as it levels the playing field between online and offline sales channels. Yet, should legislation implementing an internet sales tax pass, retailers may have to re-evaluate their channel pricing and promotion strategies. Several states are also evaluating potential changes to their sales tax regulations. If passed, compliance with a number of differing—and occasionally conflicting—sales tax regulations will pose a significant administrative and technological burden, especially for online retailers. Unlike their brick and mortar counterparts, they have not yet begun the arduous work of ensuring compliance.



Retailers also note increased concern over environmental and accounting regulations. Environmental concerns jumped by nearly 36 percent this year, as conservation and sustainability efforts grow increasingly popular among lawmakers and consumers alike. For example, states and municipalities are beginning to adopt various new regulations, such as banning plastic bags, that are burdensome to retailers to manage. Meanwhile, retailers are eyeing looming changes to U.S. accounting standards as the Financial Accounting Standards Board (FASB) discusses adjustments to standards related to leases, revenues and financial instruments. Over two-thirds of retailers (69 percent) cite shifting accounting standards as a risk, up from 58 percent in 2012.

▶IT SYSTEMS MAINTENANCE AND CYBERSECURITY CONCERNS ON THE RISE

Retailers are increasingly concerned over the protection of their crucial IT systems and customer and company data. Verizon's 2013 Data Breach Investigations Report recently found that retail accounted for 24 percent of data breaches in 2012, second only to financial services. In the wake of several high-profile industry security breaches, IT and data security risks were cited by the most companies in the study's history at 89 percent and 85 percent, respectively.

According to IBM, 90 percent of the world's data has been created in the past two years. Retailers are at the center of this "big data" revolution, given their increasing focus on gathering and analyzing consumer and market data in order to improve operations and sales. In addition, information technology software and data are increasingly moving from behind the corporate firewalls to the cloud. While cloud computing solutions invest heavily in protecting security and privacy, arguably resulting in more secure solutions, this change causes discomfort to many traditional retail executives who are used to being able to completely control IT security internally.

"Data protection is critical given that retailers process and retain a tremendous amount of sensitive data through credit card transactions, loyalty programs, online shopping and social media," said **Doug Hart, partner in the Retail and Consumer Products practice at BDO USA, LLP**. "Further, the increasing reliance on cloud computing solutions to process and store this data adds another dimension to this security and privacy risk."

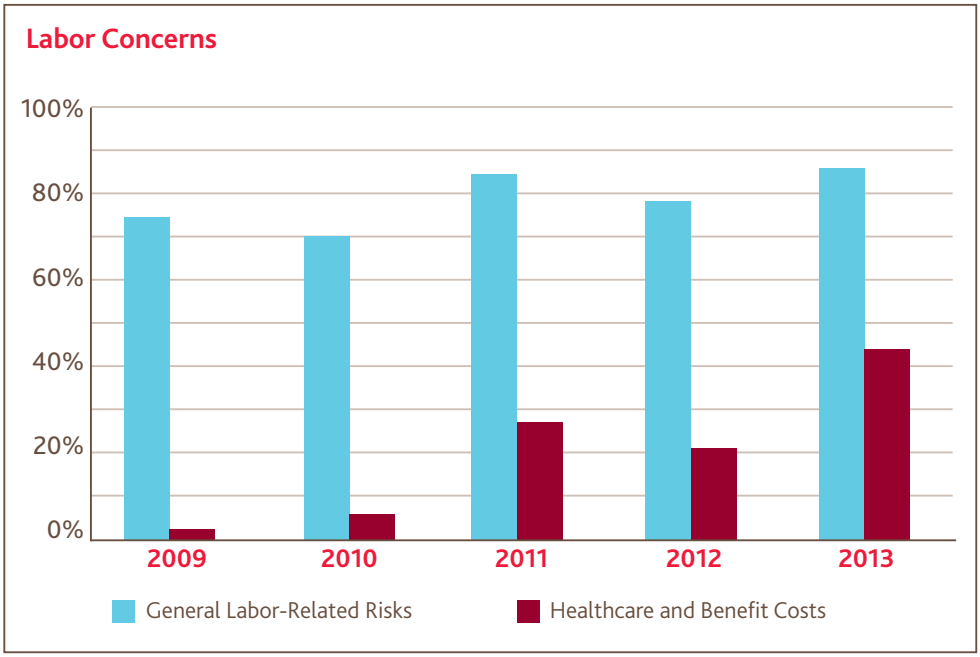
▶Read more

Top 20 Risks for Retailers	2013		2012		2011		2010	
General Economic Conditions	#1	100%	#1	99%	#1	97%	#1	96%
Federal, State and/or Local Regulations	#2	97%	#4	85%	#4	92%	#6	72%
U.S. and Foreign Supplier/Vendor Concerns	#3	95%	#2	97%	#2	95%	#2	86%
Competition & Consolidation in Retail Sector	#4	94%	#3	94%	#2t	95%	#3	85%
Implementation & Maintenance of IT Systems	#5	89%	#6	83%	#12	73%	#10	64%
Labor (health coverage, union concerns, staffing)	#6	86%	#10	78%	#7	84%	#7	70%
Credit Markets/Availability of Financing and Company Indebtedness	#6t	86%	#8	82%	#6	86%	#4	84%
Privacy Concerns Related to Security Breach	#8	85%	#12	72%	#19	55%	#16	51%
Dependency on Consumer Trends	#8t	85%	#6t	83%	#5	87%	#11	63%
Consumer Confidence and Spending	#10	84%	#9	81%	#11	77%	#5	83%
Natural Disasters, Terrorism and Geopolitical Events	#11	83%	#5	84%	#9	83%	#7t	70%
Failure to Properly Execute Business Strategy	#12	79%	#13	68%	#10	80%	#20	43%
Legal Proceedings	#13	78%	#11	73%	#7t	84%	#12	62%
International Operations	#14	76%	#13t	68%	#15	70%	#15	55%
Changes to Accounting Standards and Regulations	#15	69%	#17	58%	#14	72%	#13	58%
Loss of Key Management/New Management	#16	68%	#15	63%	#12t	73%	#17	49%
Insurance Costs & Uninsured Liabilities	#17	63%	#20	46%	#21	53%	#21t	40%
Consumer Credit and/or Debt Levels	#18	61%	#16	59%	#17	65%	#9	69%
Environmental Laws, Regulations & Liability	#19	57%	#22	42%	#26	43%	#28t	23%
Impediments to Further U.S. Expansion and Growth	#20	56%	#20t	46%	#16	67%	#14	57%

*t indicates a tie in the risk factor ranking

▶LABOR CONCERNS RISE AMID INCREASED COMPETITION & COSTS

The number of retailers citing risks related to labor increased 10 percent this year, making it the sixth most cited risk. Two critical external factors are likely contributing to the jump. Given the large retail workforce, retailers are wary of the increases to the cost of labor that the Affordable Care Act will impose when it enters into full force in 2014. The number of retailers noting healthcare costs as a risk more than doubled this year, rising to 43 percent from 20 percent, as retailers work to determine the best way to extend health insurance benefits for newly qualified employees. At the same time, a slightly improved job market means that competition for these employees is rising. Retailers must carefully balance the need to offer potential employees incentives to sign on while managing the rise in benefit costs.



▶Read more

"Natural disasters are occurring with greater frequency and severity," said **Clark Schweers, managing director at BDO Consulting and head of the firm's Insurance Claim Services practice**. "Many retailers suffered significant financial losses after Sandy impacted the most populous region in the United States. It is very important for retailers to proactively review their property insurance policies to ensure that their policy will be triggered for the various perils that could affect their business."

▶SUPPLY CHAIN & INTERNATIONAL RISKS REMAIN PREVALENT

After ranking second for the past three years, supply chain risks fell slightly to the third most cited concern among retailers. This is partly due to decreased concerns over commodity costs, as 72 percent of those who disclosed supply chain risks cited commodity costs as a risk this year, down from 81 percent in 2012 and 84 percent in 2011. However, despite stabilizing costs, global retail supply chains are causing an uptick in international operations risks (cited by 76 percent of retailers, up from 68 percent in 2012). Some retailers are concerned about the ability of their contract manufacturers in China to retain qualified labor as the workforce matures and the younger generation appears to be less attracted to the sector. Moreover, growing international operations expose retailers to volatile foreign currency exchange rates, which were noted by 40 percent of retailers as a risk.

Regulatory concerns are also impacting international growth. This year, over one-quarter of retailers (27 percent) indicated that the U.S. Foreign Corrupt Practices Act (FCPA) may create liabilities and increase the cost of regulatory compliance in the coming year. As major retailers continue to grapple with implementing effective FCPA compliance programs, particularly as it relates to managing the activities of third parties overseas, we expect to see this risk increase.

▶INSURING AGAINST BUSINESS DISRUPTION BECOMES A BIGGER CHALLENGE

With extreme weather and international political instability growing more common and visible—and more likely to disrupt business operations—retailers have shifted their attention this year to better preparing themselves for potential business interruptions. However, the insurance retailers are seeking to protect themselves from business interruption-related losses is itself risky for businesses. This year, the proportion of retailers citing the cost and availability of insurance as a potential risk grew by 37 percent.

Yet there is no doubt that planning for future disruptions remains as important as ever. According to IHS, Hurricane Sandy alone cost an estimated $10 to $30 billion in lost business, and MasterCard Advisors reports that Sandy cost retail businesses $4 billion in sales in the week following the storm. With this major disruption fresh in their memories, 83 percent of retailers cite natural disasters and geopolitical events as leading business risks this year.

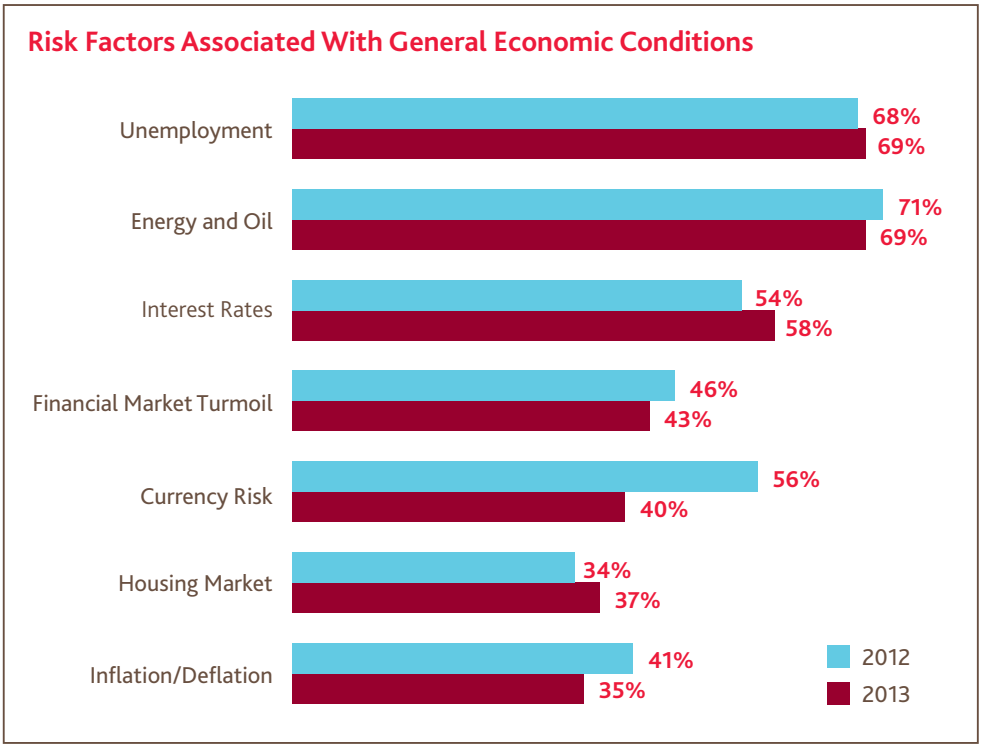
▶OMNICHANNEL GROWTH IMPACTS STRATEGIC GROWTH RISKS

A vast majority of retailers (85 percent) note concern over their ability to respond to changing consumer interests and demand. Customer preferences are driving the growing focus on omnichannel strategy, leading many retailers to expand their online and mobile channels. Yet this shift in strategy is not without risk as retailers determine the best way to effectively integrate multiple platforms in a way that consumers find intuitive and accessible. It is no surprise, then, that with the accelerating drive toward omnichannel, 79 percent of retailers express concern about properly executing their business strategy, up from 68 percent last year. U.S. expansion plans also remain high (56 percent), but expansion risks have declined since 2010 and 2011 when many retailers began to transition away from rapidly adding new stores as their primary growth strategy. For some brands, building out e-commerce and mobile capabilities may be a more efficient investment, as it can be less capital-intensive.

▶Read more

GENERAL ECONOMIC CONDITIONS CONTINUE TO CAST A SHADOW ON OPERATIONS

For the fifth consecutive year, the economic climate poses the top risk to retail businesses. Global economic recovery has limped along slowly, and many top economic concerns linger for consumers and businesses. All retailers in the top 100 cite the economy as a risk factor, with a majority of them specifically citing energy prices and unemployment levels as top influencers of economic growth. However, there are some signs of optimism. The number of retailers citing currency risk and inflation as major concerns dropped slightly this year, signaling a sense of improving stability in the wake of more assertive action by the Federal Reserve on controlling monetary fluctuations.



CREDIT RISK UNCERTAINTIES PERSIST

Retailers are slightly more concerned about consumer credit levels this year than last, with 61 percent of 10-Ks citing it as a risk factor (compared to 59 percent last year). However, retailers appear to be particularly worried about the credit risk of their vendors and major customers, with the number of retailers citing this as a risk nearly doubling since 2012. Half of the retailers studied indicate that the creditworthiness of essential counterparties could negatively impact results this year, with a number specifically expressing concern that vendors and customers could default on their obligations to the company.

Retailers are also keeping a close eye on the impact of the interchange fees on their business. While retailers won a victory with the passage of the Durbin Amendment (which ultimately limited the fees card-issuing banks could assess on credit/debit card purchases made by consumers) alongside the Dodd-Frank Wall Street Reform and Consumer Protection Act, the impact of the regulation on consumer spending and credit levels remains unclear. A number of analysts have argued that card-issuing banks pass along the cost of reduced interchange fees to the consumer in the form of increased overall card fees and the reduction of rewards and cash-back programs. Additionally, the risk remains that further regulations—ones that may not be so beneficial to retailers—may be just around the bend.

Overall, this year's RiskFactor Report for Retail Businesses indicates that external threats once again dominate retailers' list of concerns for the year ahead. As businesses grow more adept at managing their internal risks, they must now turn to finding ways to insulate themselves from—and prepare for—new developments in the regulatory and economic space.

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 over 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 USA

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 more than 40 offices and over 400 independent alliance firm locations nationwide. As an independent Member Firm of BDO International Limited, BDO serves multinational clients through a global network of 1,204 offices in 138 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. For more information, please visit www.bdo.com.

www.bdo.com