Strategies for Writing Annual Reports: An Examination of 10-Ks in the Consumer Discretionary Manufacturing Industry

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Abstract

This research project examines 10-Ks from successful companies in the consumer discretionary manufacturing industry in order to expand upon the limited information available for strategically writing 10-Ks. The data and examples are collected from the fiscal year 2022 10-Ks of the seven companies from the Nasdaq 100 that manufacture in-house consumer discretionary products. The research and strategies focus on item 5 and item 7 of the 10-K, which provide the most freedom to writers and opportunities to influence investor decision making. The results highlight the importance of non-required information that improves investor outlook, visuals and footnotes as a tool to manage emphasis, non-financial reporting such as including company values, and potential risk and mitigation reporting. This research can be used to strategically maximize 10-Ks for improving stock price outcomes and decreasing volatility.

Keywords: 10-K, Corporate reports, Investor relations, Corporate finance, SEC

Introduction

The United States Securities and Exchange Commission (SEC) requires all public companies to submit an annual report called a 10-K. These documents help the government ensure that companies comply with regulations and increase transparency to the public. However, 10-Ks are also important for maintaining investor relations because investors use them to evaluate a company's financial health and future productivity to decide whether they should buy, hold, or sell its stock.

As required by the SEC, 10-Ks contain four parts with fifteen items providing an overview of the business, description of the risks it faces, important assets and legal events, stock and equity information, analysis of performance, internal controls, and various graphs and tables of financial data. This report focuses on two items in Part II of 10-K documents: Item 5, which includes information on the company's stock, equities, and 5-year returns, as well as Item 7, which includes management's discussion and analysis of financial conditions and operating results. These two items are critical to managing investor sentiments because they provide key information about the company's stock, which is what ties investors to the company, and "allow company management to tell its story in its own words," which provides an opportunity to direct investors' attention towards that year's successes and future opportunities. (SEC Investor Bulletin, 2011, p. 2).

Despite the crucial need for companies to write compelling 10-K reports to attract and maintain public investment, there is little information available on how to write the document because most companies avoid sharing their strategies with competitors. Even though 10-Ks have a required overall structure, there is substantial complexity in considering the details of the 10-K. For example, 10-Ks often make predictions based on trends in past performance, projects that the company is working on, and analysis of changes in the market. While these predictions create opportunities for creativity and persuasion directed at investors, documents in corporate finance must find a balance between being compelling and appearing factual as well as unbiased. Furthermore, as stock markets react to news increasingly faster, it becomes more important for companies to control the initial reaction to annual updates by having compelling investor releases.

In light of these challenges, the purpose of this research is to investigate and compile strategies that companies can use in their annual investor reports to help keep investor confidence high, which is especially important after a period of poor financial performance. These findings aim to help companies recover from temporary financial setbacks, which has the potential to improve the stability of companies, jobs, and markets.

Methods

This work draws upon a variety of industry guides on how to write corporate reports and interact with investors including articles published by Fidelity Investments, work written by members of the National Association of Corporate Directors, and most notably Steven M. Bragg's guidebook *Running an Effective Investor Relations Department: A Comprehensive Guide*.

This research also uses data and examples collected from the 10-Ks of companies listed on the Nasdaq-100 under the consumer discretionary industry breakdown. The sample was further narrowed down only to companies that manufacture their own products for commercial sale. This selection process was used to narrow the scope of the research for greater depth and to select companies that provide discussion of supplier relations, manufacturing, supply chain factors, marketing, sales channels, and distribution. This wide range of business activities will help to create a more complete 10-K writing guide that is applicable to other industries and business challenges. Using these filters, the following seven companies' 10-Ks were studied: PACCAR Inc., Cintas Corp., Fastenal Company, Starbucks Corp., Lululemon Athletica Inc., Costco Wholesale Corp., and Lucid Group Inc.

Results and Discussion

Using these sources, the research focuses on four main areas: inclusion and analysis of financial information, different methods of presenting and emphasizing information, financial versus non-financial reporting, and potential risk and mitigation reporting. These categories indicate the types of information that 10-Ks should include, how they should be presented, and the scenarios in which different information is most compelling and appropriate.

Inclusion and Analysis of Financial Information

The SEC requires certain types of financial information to be in item 5 of the 10-K including the ticker, the quantity of shareholders, and described the payment of dividends. The 10-K format also allows companies to include additional financial information. For example, five out of the seven sampled companies, PACCAR, Starbucks, Lululemon, Costco, and Lucid, also included optional expectations of future dividend payments. An article by Fidelity International explains the impact of these dividend expectations on investors. Dividends, which are the distribution of profits back to investors, "are often viewed by investors as a sign of a company's strength and that the company's management has positive expectations around future earning's growth," which can "incentivize them to continue holding the stocks" (Fidelity). As a result, the optional inclusion of future dividend expectations can be a valuable tool for companies to include in their 10-K in order to project strong financial health to investors.

Following this strategy, Costco includes its future dividend expectations by announcing, “We presently expect to continue to pay dividends on a quarterly basis” (Costco, 2023, p. 19). This policy is consistent with Costco’s historical dividend returns, serving as a reminder and assurance to investors that Costco will continue paying dividends, which is an attractive reason to buy or hold onto the stock. Considering that Costco failed to meet earnings expectations by 1.27% leading up to this 10-K,[1] it is strategic to remind investors of the steady dividend returns that they receive regardless of the underperforming earnings.

On the contrary, Lululemon beat earnings expectations by 3.53% and claimed, “We do not anticipate paying any cash dividends on our common stock in the foreseeable future,” (Lululemon, 2023, p. 22) which is a continuation of its historical dividend policy. This strategy is more appropriate for Lululemon because investors are more attracted to the company consistently beating earnings expectations and not having dividends helps Lululemon to keep earnings high. Therefore, investors are more accepting of Lululemon not paying dividends as long as the company continues overperforming on earnings, which will cause the stock’s value to grow.

Despite having consistent dividend payouts, Fastenal did not provide dividend expectations, deviating from the strategy of including dividend expectations. However, Fastenal did incorporate its dividend returns into the five-year graph of its stock performance later in item 5. Since Fastenal pays dividends so consistently and investors are aware of it already, the 10-K did not require further assurance of dividend returns. Instead, the company included the dividends in its graph of returns in order to present higher returns on its stock. This dividend presentation is important for Fastenal because its stock value decreased relative to competitors and the overall market in the fiscal year for the 10-K, which may be a cause for investor concern. For that reason, projecting high stock returns by incorporating dividends into share growth is more effective in appealing to investors and reducing concerns of low stock growth.

In this way, optional information such as dividend expectations should be included if it provides confidence to investors in greater returns or if it depicts an emphasis on some beneficial aspect of the company that differentiates it from competitors. However, optional information should not be included if it serves no benefit to investors, such as with Fastenal not including dividend expectations because it provided more confidence to include it with stock returns. All non-required information should be carefully evaluated and only included if it serves to benefit and improve outlook for investors.

Different Methods of Presenting and Emphasizing Information

The next section of item 5 includes information on outstanding shares, stock compensation plans, sales of unregistered securities, and stock repurchase programs. However, there is considerable variation in the way that the seven companies presented their stock repurchase programs as some included it in the main body of text, some included it in footnotes, and others added data tables to present it. This variation stems from the impact of the companies’ stock repurchases, which can be understood through Bragg’s guidebook, which provides some of the most in-depth explanation and strategies for writing corporate reports currently available to the public. Bragg reveals, “A stock repurchasing program sends a signal to the market that the company considers its stock to

[1] Actual versus expected earnings information for fiscal year 2022 is in Figure 1 and Figure 2 in the appendix.

be undervalued" (Bragg, 2010, p. 10). These repurchasing programs indicate to investors that the company has strong underlying fundamentals and is likely to increase in share price.

For this reason, Lululemon included an additional half-page table in item 5 with data regarding the company's stock repurchase program. Placing the information in a large data table draws added attention to the importance of the stock repurchase programs. As stated by Bragg, this repurchasing program reinforces investor confidence by highlighting management's assurance in the company's fundamental business model, customer base, and share price growth. Therefore, it benefits Lululemon to emphasize this information with an optionally included table.

Cintas takes the opposite approach, minimizing its stock repurchase information into smaller footnotes. Bragg reasons that "the IRO [investor relations officer] should advise against a stock purchase only if the contemplated repurchase is so large that the float [available shares] will be seriously reduced" (Bragg, 2010, p. 10). In order to increase its share price and earnings per share, Cintas authorized the repurchase of a relatively large number of shares valued at $2.5 billion. While such a large repurchasing program may be beneficial for the company, it may harm public investors by decreasing the float considerably. Therefore, by making its stock repurchase information smaller in a footnote, Cintas places less emphasis on it and the potential threat it poses to investors.

There are a few options for presenting information in a 10-K based on the potential effects it may have for investors as seen with stock repurchase programs. The most common is to create an ordinary subheading for it in the main body of text such as how Starbucks included their stock repurchase information in the subsection "Issuer Purchases of Equity Securities" (Starbucks, 2023, p. 23). However, if management is looking to emphasize some information because it boosts investor confidence or portrays financial strength, then it should be included in a prominent data table or some other visual. In contrast, if a company is looking to decrease attention to some information that hurts investors, the information should be included in a footnote. The format of a 10-K is relatively flexible, so companies can take advantage by using visuals and footnotes[2] to feature information with emphasis based on the order of importance of what is most compelling to investors.

Financial Versus Non-Financial Reporting

Item 7, containing management's discussion and analysis of financial conditions and results of operations, is one of the most substantial sections of the entire 10-K. It gives companies the freedom to discuss the aspects of the business that they want to emphasize and that will present the greatest value to shareholders. Each of the 10-Ks began item 7 with an overview of the company, including a breakdown of the different aspects and branches of the business. After a couple pages of analysis, each 10-K then included an abbreviated income statement followed by more financial data. The analysis between this business overview and income statement reflects the most important takeaways and results of the business's performance in the fiscal year.

One consideration for this critical section of analysis in item 7 is the inclusion of financial versus non-financial reporting. While item 5 of the 10-K includes almost exclusively financial information for all 7 companies, item 7 incorporates more non-financial reporting. A LinkedIn article by Jason Morris, a corporate director at the G-CON biotechnology company, explains the importance of non-financial objectives: "Non-financial objectives are more qualitative and subjective, such as enhancing employee satisfaction, improving customer experience, or

[2]As a guide for the quantities of pages, tables, graphs, and footnotes to include in items 5 and 7, that information is included for the seven companies' fiscal year 2022 10-Ks in Figure 3 in the appendix.

supporting social causes. Both types of objectives are important for your long-term success" (Morris). Morris also states that companies "need to prioritize" financial and non-financial objectives, "weight the trade-offs involved," and implement objectives that "communicate your values and vision to your stakeholders" (Morris). Morris illuminates that writing 10-Ks should involve carefully evaluating the benefits and consequences of different financial and non-financial reporting in the context of each situation.

Discussing company values and missions can be an effective form of non-financial reporting. An article by Forbes expounds that "your values and mission are what ultimately drive your team's performance" and "careful integration of values with the strategy, mission, and goals have a direct and measurable impact on scalability and profit" (Forbes, 2021). For this reason, in item 7 Cintas states its mission "to exceed customers' expectations in order to maximize the long-term value of Cintas for shareholders and working partners" and their slogan "Cintas helps customers get *Ready for the Workday*" (Cintas, 2023, p.18). Similarly, Lucid states its "mission to inspire the adoption of sustainable energy by creating advanced technologies and the most captivating luxury electric vehicles, centered around the human experience" (Lucid, 2023, p. 71). Fastenal states, "Our tagline [is] *Where Industry Meets Innovation*" (Fastenal, 2023, p. 28), and Costco states, "Our philosophy is to provide our members with quality goods and services at competitive prices" (Costco, 2023, p. 21). The reporting of these company values reminds investors of the strategic focuses of the company that will help distinguish the company from competitors. Therefore, non-financial information, such as a well-crafted mission and values, should be included in item 7 if it has been integrated into a company's decision-making and improves growth and profitability.

Potential Risk and Mitigation Reporting

Returning to Bragg's guidebook exposes the importance of risk reporting because "if investors cannot quantify these risks, they then will probably discount the company's stock price by an inordinate amount" (Bragg, 2010, p. 30). Bragg portends that risk reporting prevents investors from overestimating risk and that "to avoid an excessive stock price reduction" companies should "lay out the key problems" and "describe how the company intends to resolve them" (Bragg, 2010, p. 30). Using this technique to demonstrate how the company understands and is mitigating risks helps to temper investors' concerns and reduces stock price variability.

PACCAR illustrates risk reporting in item 7 of its 10-K by stating, "The Company has been affected by an industry-wide undersupply of component parts and anticipates the shortage may continue to affect deliveries in 2023" (PACCAR, 2023, p. 17). Although this admission highlights a weakness in the company's supply chain, it still assures PACCAR's investors that there is an understanding of the problem and that the issue will not worsen. Starbucks takes this risk reporting one step further in their 10-K by outlining risk mitigation strategies. Starbucks acknowledged that they "expect inflationary pressures on commodities and supply chain to continue" in 2023, but that the resulting loss in revenue "should be offset by benefits from pricing decisions as well as from increased sales leverage and higher productivity driven by our Reinvention Plan" (Starbucks, 2023, p. 26). By acknowledging a potential risk and clearly identifying two mitigation strategies, Starbucks gave investors the confidence that the company will not let inflationary risk decrease profitability.

Bragg additionally outlines a less common risk reporting strategy that may be beneficial in situations where investors have greater concerns: "Another option for clarifying risk is to develop a worst-case scenario […] and create a contingency plan for how the company would deal with such a situation" (Bragg, 2010, p. 32). Lucid employed this approach by theorizing about the possibility of "a global economic recession," which would cause "customers to defer purchases or cancel their reservations and orders in response to higher interest rates […] and weakened consumer confidence" (Lucid, 2023, p. 72) Due to Lucid's lack of profitability, investors have high concerns about the effects of a recession on the company, so Lucid's contingency plan helps put that risk into perspective and stabilize investor sentiments.

Item 7 of the 10-K should include some form of risk reporting, the extent of which is dependent on the level of investor concern. For smaller risk concerns, a one or two sentence acknowledgement is sufficient to demonstrate awareness of the risk. For risks that pose a greater threat to a company's operations and sales, some mitigation strategies should also be included to evidence steps that will limit the potential downside. For catastrophic risks that have the potential to significantly hurt investor returns or bankrupt the company, a worst-case scenario should be covered to instill confidence in the company's ability to handle such a situation.

Conclusion

The annual 10-K is vital for a companies' stock price and volatility because it is used by investors to evaluate a company's financial health and productivity to decide on buying, holding, or selling its stock. While the 10-K has components required by the SEC, there is considerable freedom and decision-making for corporate writers, who must determine how to positively influence investor sentiments. In order to help writers maximize the 10-K's benefits there are four main takeaways from this research for writing 10-K reports. Non-required information should only be included if it can be presented in a way that improves investor outlook, visuals and footnotes should be used to increased and decrease the attention given to specific information based on its benefit to investors, non-financial reporting such as values and missions is critical in item 7, and acknowledging risks with mitigation strategies or worst-case scenarios is important to sedating investor fears as well as reducing volatility. This research expands the limited information available on writing 10-Ks and is intended to act as a guide for writing the less rigid aspects of item 5 and item 7. While past research mainly provides technical guidelines such as required information, this research focuses on strategically writing for the greatest impact on investors. However, the findings may not apply as accurately to companies outside of consumer discretionary and manufacturing industry due to the limited sample. Further research may include different industries, greater research scale, and other types of financial reports. Companies looking to improve their stock outcomes and decrease volatility should employ this research to more effectively evaluate each decision and piece of information in their 10-Ks based on how it will affect investors' view of the companies past performance and future potential.

Acknowledgments

I would like to thank Dr. Caroline Cole for guiding me throughout the research and writing process, answering my questions in office hours with invaluable feedback, and teaching me the skills to complete this project throughout the semester. I also thank the organizers and participants of the Chiang Research Festival who provided helpful ideas and constructive feedback to improve this paper. I would also like to thank Brad Yu and Jatin Palvai for peer reviewing this project multiple times throughout the research process and helping to define the scope and structure of the project.

Appendix

Figure 1

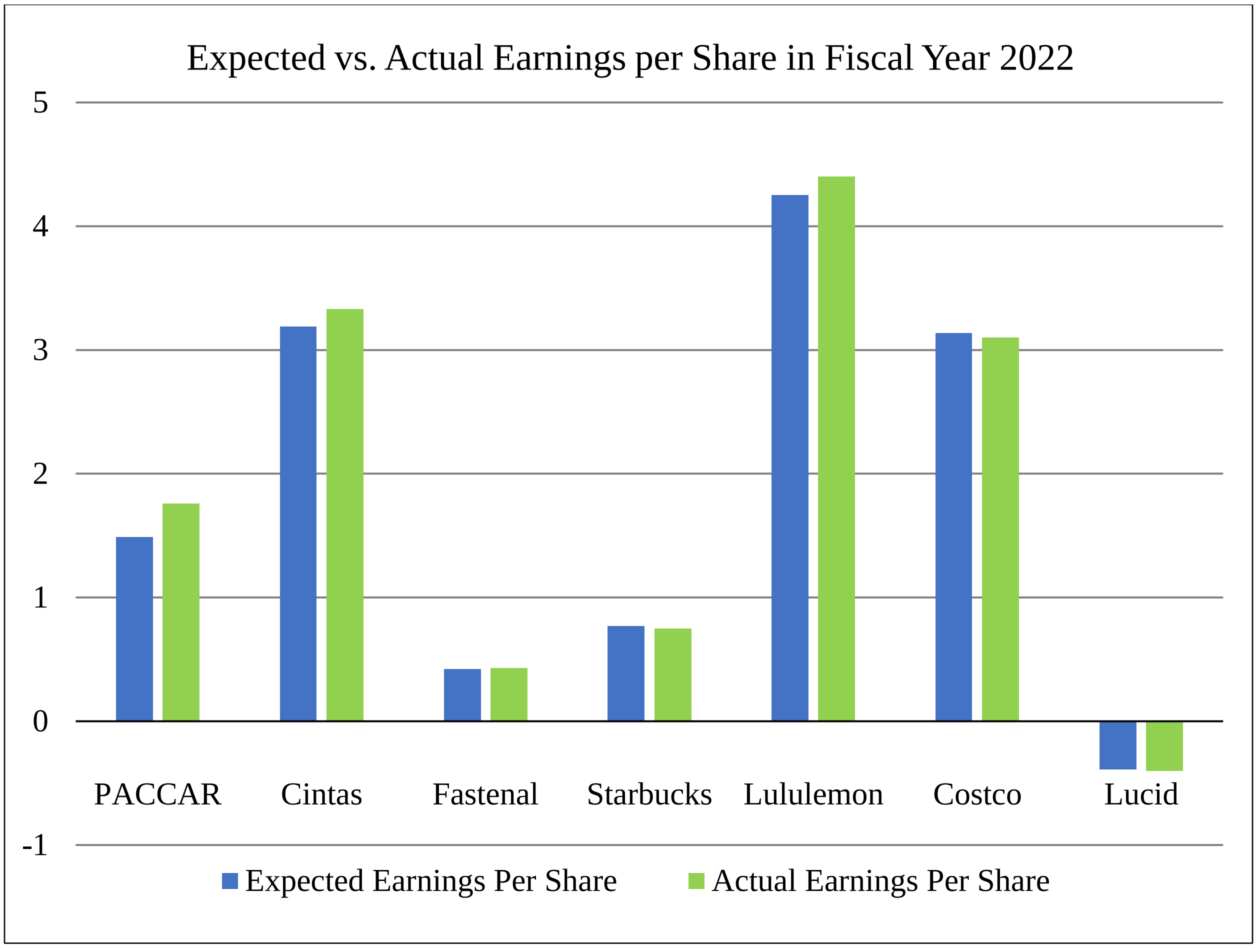

Figure 2

2022 Fiscal Year	PACCAR	Cintas	Fastenal	Starbucks	Lululemon	Costco	Lucid
Expected Earnings Per Share	1.76	3.33	0.43	0.75	4.4	3.1	-0.4
Actual Earnings Per Share	1.49	3.19	0.42	0.77	4.25	3.14	-0.39
Percent Difference	18.12%	4.39%	2.38%	-2.60%	3.53%	-1.27%	-2.56%

Figure 3

2022 10-Ks	Item 5				Item 7			
	Pages	Tables	Graphs	Footnotes	Pages	Tables	Graphs	Footnotes
PACCAR	2	2	1	0	16	21	0	2
Cintas	2	2	1	4	12	11	0	9
Fastenal	2	2	1	1	23	44	2	12
Starbucks	2	1	1	0	15	11	0	4
Lululemon	2	3	1	4	17	20	0	3
Costco	2	2	1	1	10	8	0	0
Lucid	2	0	1	0	15	6	0	0
Average	**2**	**1.71**	**1**	**1.43**	**15.43**	**17.29**	**0.29**	**4.57**

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