CHS INC
Form 10-K
December 03, 2018
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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

þ	ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the fiscal year ended August 31, 2018
or	
o	TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the transition period from to .

Commission file number: 001-36079

CHS Inc.
(Exact name of Registrant as specified in its charter)

Minnesota	41-0251095
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
5500 Cenex Drive Inver Grove Heights, Minnesota 55077	(651) 355-6000
(Address of principal executive office, including zip code)	(Registrant's telephone number, including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

8% Cumulative Redeemable Preferred Stock	The Nasdaq Stock Market LLC
Class B Cumulative Redeemable Preferred Stock, Series 1	The Nasdaq Stock Market LLC
Class B Reset Rate Cumulative Redeemable Preferred Stock, Series 2	The Nasdaq Stock Market LLC
Class B Reset Rate Cumulative Redeemable Preferred Stock, Series 3	The Nasdaq Stock Market LLC
Class B Cumulative Redeemable Preferred Stock, Series 4	The Nasdaq Stock Market LLC
(Title of Each Class)	(Name of Each Exchange on Which Registered)

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT: NONE

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
YES o NO þ

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.
YES o NO þ

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 þ NO o

Indicate by check mark whether the Registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit such files).
YES þ NO o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405) is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K: þ

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o	Non-accelerated filer þ	Smaller reporting company o	Emerging growth company o

If an emerging growth company, indicate by check mark if the Registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act).
YES o NO þ

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the Registrant's most recently completed second fiscal quarter:

The Registrant has no voting or non-voting common equity (the Registrant is a member cooperative).

Indicate the number of shares outstanding of each of the Registrant's classes of common stock, as of the latest practicable date:

The Registrant has no common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE
None.

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EXPLANATORY NOTE

General

On October 22, 2018, the Audit Committee of the Board of Directors (the “Audit Committee”) of CHS Inc. (the “Company”, "we", "us" or "our"), after considering the recommendations of management, concluded that our audited consolidated financial statements for the fiscal years ended August 31, 2017, 2016, and 2015, included in our Annual Report on Form 10-K for the fiscal year ended August 31, 2017 (the “2017 Annual Report”), and our unaudited consolidated financial statements for the quarterly periods ended November 30, 2017 and 2016, February 28, 2018 and 2017, and May 31, 2018 and 2017, included in our Quarterly Reports on Form 10-Q for the quarterly periods ended November 30, 2017, February 28, 2018, and May 31, 2018 (the "2018 Quarterly Reports”), should no longer be relied upon due to misstatements that are described in greater detail below, and that we would restate such financial statements to make the necessary accounting corrections.

The Restatement

This Annual Report on Form 10-K for the year ended August 31, 2018, includes audited consolidated financial statements for the years ended August 31, 2018, 2017, and 2016, as well as relevant unaudited interim financial information for the quarterly periods ended November 30, 2017 and 2016, February 28, 2018 and 2017, May 31, 2018 and 2017, and August 31, 2018 and 2017. The consolidated financial statements for the years ended August 31, 2017 and 2016, selected financial data (Item 6. "Selected Financial Data") for the years ended August 31, 2015 and 2014, and relevant unaudited interim financial information for the quarterly periods ended November 30, 2017 and 2016, February 28, 2018 and 2017, May 31, 2018 and 2017, and August 31, 2017, included within this Annual Report on Form 10-K have been restated.

Restatement Background

As described in the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission ("SEC") on October 26, 2018, management of the Company noted potentially excessive valuations in the net derivative asset valuations relating to certain rail freight contracts purchased in connection with our North American grain marketing operations during the preparation of our Annual Report on Form 10-K for the year ended August 31, 2018. Following our identification of these potentially excessive valuations, the Company engaged external counsel, which engaged forensic accountants to work with management of the Company under the oversight of the Audit Committee to conduct an investigation.

The investigation concluded that the misstatements in our consolidated financial statements included in the 2017 Annual Report and 2018 Quarterly Reports were due to intentional misconduct by a former employee in our rail freight trading operations, as well as due to freight contracts not meeting the technical accounting requirements to qualify as derivative financial instruments. The misconduct consisted of the former employee manipulating the mark-to-market valuation of rail cars that were the subject of rail freight purchase contracts and manipulating the quantity of rail cars included in the monthly mark-to-market valuation. In addition, the investigation revealed intentional misstatements were made by the former employee to our independent registered public accounting firm in connection with its audit of our consolidated financial statements for the fiscal year ended August 31, 2017. During the course of, and as a result of, the investigation, we terminated the former employee and have taken additional personnel actions.

Based on the findings described above, we performed additional reviews and analysis, re-performed certain accounting procedures, reviewed our accounting policies and restated certain accounting records for fiscal 2018 and prior periods. The Audit Committee, management and the Company's legal counsel reported the findings of the investigation to our Board of Directors and to our independent registered public accounting firm, and have discussed the evidence uncovered and conclusions reached in the investigation with the Staff of the Division of Enforcement of the SEC.

As a result of the work performed in relation to the freight misstatement, additional misstatements related to the elimination of intercompany balances were also identified and corrected. Although these intercompany misstatements resulted in a material misstatement of certain financial statement line items, the intercompany misstatements did not result in a material misstatement of income (loss) before income taxes or net income (loss).

Restatement of Previously Reported Consolidated Financial Information

This Annual Report on Form 10-K restates amounts included in the 2017 Annual Report described above, including the audited consolidated financial statements for the years ended August 31, 2017 and 2016. Selected financial information for fiscal years ended August 31, 2015 and 2014, and relevant unaudited interim financial information for the quarterly periods ended November 30, 2017 and 2016, February 28, 2018 and 2017, May 31, 2018 and 2017, and August 31, 2017, have also

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been restated. In addition to the misstatements related to the freight contracts and intercompany eliminations, we made adjustments related to other previously identified misstatements unrelated to the freight derivatives and related misstatements that were not material, individually or in the aggregate, to our consolidated financial statements. These other misstatements relate primarily to certain misclassifications, adjustments to revenues and cost of goods sold, and adjustments to various income tax and indirect tax accounts. The following tables present the summary impacts of the restatement adjustments on our previously reported consolidated capital reserves and total equities at August 31, 2015, and income (loss) before income taxes and net income (loss) for the years ended August 31, 2017 and 2016:

	August 31, 2015	
	Capital Reserves	Total Equities
	(Dollars in thousands)	
As previously reported	$1,604,670	$7,669,411
Cumulative restatement adjustments	(119,237)	(117,972)
As restated	$1,485,433	$7,551,439

	For the Years Ended August 31,	
	2017	2016
	(Dollars in thousands)	
Income (loss) before income taxes - As previously reported	$(54,852)	$419,878
Restatement adjustments	(55,314)	(17,753)
Income (loss) before income taxes - As restated	$(110,166)	$402,125
Net income (loss) - As previously reported	$127,223	$423,969
Restatement adjustments	(56,265)	(40,943)
Net income (loss) - As restated	$70,958	$383,026

For more information regarding the restatement and its impact on our consolidated financial statements, refer to the "Selected Financial Data" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" sections included within Item 6 and Item 7, respectively, of this Annual Report on Form 10-K and Note 2, Restatement of Previously Issued Consolidated Financial Statements and Note 18, Quarterly Financial Information (Unaudited) of the Notes to the Consolidated Financial Statements included within this Annual Report on Form 10-K.

Compensation Recovery

In connection with the restatement, Mr. Debertin and certain of our other named executive officers and other current senior executives, voluntarily asked our Board of Directors to reduce their award under our fiscal 2018 annual variable pay plan by an amount equal to the incentive compensation received by each such current senior executive under certain incentive compensation plans with respect to prior fiscal years that was in excess of what would have been earned by such current senior executive after taking into account the restatement of our consolidated financial statements. Our Board of Directors accepted such requests and reduced each affected executive’s earned annual variable pay for fiscal 2018 by the amount of that excess. Additionally, each of our current directors who was serving as a director in fiscal 2016 voluntarily returned an amount previously credited to such director’s retirement plan account under our deferred compensation plan in that fiscal year, equal to the excess of what would have been credited to such director’s account after taking into account the restatement of our consolidated financial statements. For more information regarding these compensation recovery actions and recovery actions regarding former executives and directors, refer to the “Annual Variable Pay”, “Compensation Recovery” and “Director Compensation” subsections included in Item 11 of this Annual Report on Form 10-K.

Control Considerations

In connection with the restatement, management has assessed the effectiveness of our disclosure controls and procedures and has included applicable disclosure in Item 9A of this Annual Report on Form 10-K, "Controls and Procedures." Management identified material weaknesses in our internal control over financial reporting as described under "Management's Report on Internal Control over Financial Reporting" in Item 9A of this Form 10-K, resulting in the conclusion by our Chief Executive Officer and Chief Financial Officer that our disclosure controls and procedures and internal control over financial

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reporting were not effective at a reasonable assurance level as of August 31, 2018. Management has taken and is taking additional steps, as described under "Remediation Plan and Status" in Item 9A of this Annual Report on Form 10-K, to remediate the material weaknesses in our internal control over financial reporting.

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PART I.

ITEM 1. BUSINESS

THE COMPANY

CHS Inc. (referred to herein as “CHS,” “we” or “us”) is the nation’s leading integrated agricultural cooperative, providing grain, foods and energy resources to businesses and consumers on a global basis. As a cooperative, we are owned by farmers and ranchers and their member cooperatives (referred to herein as “members”) across the United States. We also have preferred shareholders that own shares of our five series of preferred stock, which are each listed and traded on the Nasdaq Global Select Market. We buy commodities from and provide products and services to individual agricultural producers, local cooperatives and other companies (including our members and other non-member customers), both domestically and internationally. We provide a wide variety of products and services, ranging from initial agricultural inputs such as fuels, farm supplies, crop nutrients and crop protection products, to agricultural outputs that include grains and oilseeds, grain and oilseed processing, renewable fuels and food products. A portion of our operations are conducted through equity investments and joint ventures whose operating results are not fully consolidated with our results; rather, a proportionate share of the income or loss from those equity investments and joint ventures is included as a component of our net income using the equity method of accounting. For the year ended August 31, 2018, our total revenues were $32.7 billion and net income attributable to CHS Inc. was $775.9 million.

We have aligned our segments based on an assessment of how our businesses operate and the products and services they sell. Our Energy segment derives its revenues through refining, wholesaling and retailing of petroleum products. Our Ag segment derives its revenues through the origination and marketing of grain, including: service activities conducted at export terminals; through wholesale sales of crop nutrients; from sales of soybean meal, soybean refined oil and soyflour products; through the production and marketing of renewable fuels; and through retail sales of petroleum and agronomy products, processed sunflowers, feed and farm supplies. Our Ag segment also records equity income from our grain export joint venture and other investments. Our Nitrogen Production segment consists solely of our equity method investment in CF Industries Nitrogen, LLC (“CF Nitrogen”). Our other business operations, primarily our financing and hedging businesses, are included in Corporate and Other because of the nature of their products and services, as well as the relative amount of revenues for those businesses. Prior to its sale on May 4, 2018, our insurance business was also included in Corporate and Other. In addition, our non-consolidated wheat milling and food production and distribution joint ventures are included in Corporate and Other.

Our earnings from cooperative business are allocated to members (and to a limited extent, to non-members with which we have agreed to do business on a patronage basis) based on the volume of business they do with us. We allocate these earnings to our patrons in the form of patronage refunds (which are also called patronage dividends), which may be in cash, patrons’ equities (in the form of capital equity certificates), or both. Patrons' equities may be redeemed over time solely at the discretion of our Board of Directors. Earnings derived from non-members, which are not treated as patronage, are taxed at federal and state statutory corporate rates and are retained by us as unallocated capital reserves. We also receive patronage refunds from the cooperatives in which we are a member, if those cooperatives have earnings to distribute and if we qualify for patronage refunds from them.

Our origins date back to the early 1930s with the founding of our predecessor companies, Cenex, Inc. and Harvest States Cooperatives. CHS Inc. emerged as the result of the merger of those two entities in 1998, and is headquartered in Inver Grove Heights, Minnesota.

Our internet address is www.chsinc.com. The information contained on our website is not part of, and is not incorporated in, this Annual Report on Form 10-K or any other report we file with or furnish to the SEC.

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ENERGY

Overview

We are the nation's largest cooperative energy company based on revenues and identifiable assets, with operations that include: petroleum refining and pipelines; the supply, marketing and distribution of refined fuels (gasoline, diesel fuel and other energy products); the blending, sale and distribution of lubricants; and the wholesale supply of propane and other natural gas liquids. Our Energy segment processes crude oil into refined petroleum products at our refineries in Laurel, Montana and McPherson, Kansas and sells those products under the Cenex® brand to member cooperatives and other independent retailers through a network of nearly 1,500 sites, the majority of which are convenience stores marketing Cenex® branded fuels. For fiscal 2018, our Energy revenues, after elimination of intersegment revenues, were $7.6 billion and were primarily from gasoline and diesel fuel.

Operations

Laurel Refinery. Our Laurel, Montana refinery processes medium and high sulfur crude oil into refined petroleum products that primarily include gasoline, diesel fuel, petroleum coke and asphalt. Our Laurel, Montana refinery sources approximately 93% of its crude oil supply from Canada, with the remaining balance obtained from domestic sources, and we have access to Canadian and northwest Montana crude oil through our wholly-owned Front Range Pipeline, LLC and other common carrier pipelines. Our Laurel, Montana refinery also has access to Wyoming crude oil via common carrier pipelines from the south.

Our Laurel, Montana facility processes approximately 59,000 barrels of crude oil per day to produce refined products that consist of approximately 43% gasoline, 41% diesel fuel and other distillates, 8% asphalt, 7% petroleum coke and 1% other products. Refined fuels produced at our Laurel, Montana refinery are available: via rail cars and via the Yellowstone Pipeline to western Montana terminals and to Spokane, Washington; south via common carrier pipelines to Wyoming terminals and Denver, Colorado; and east via our wholly-owned Cenex Pipeline, LLC to Glendive, Montana and Minot, Prosper, and Fargo, North Dakota.

McPherson Refinery.   Our McPherson, Kansas refinery processes approximately 59% low and medium sulfur crude oil and approximately 41% heavy sulfur crude oil into gasoline, diesel fuel and other distillates, propane and other products. The refinery sources its crude oil through its own pipelines as well as common carrier pipelines. The low and medium sulfur crude oil is sourced from Kansas, Colorado, North Dakota, Oklahoma and Texas, and the heavy sulfur crude oil is sourced from Canada and Wyoming.

Our McPherson, Kansas refinery processes approximately 100,000 barrels of crude oil per day to produce refined products that consist of approximately 56% gasoline, 38% diesel fuel and other distillates, 2% propane and 4% other products. These products are either loaded into trucks at the McPherson, Kansas refinery or shipped via common carrier pipelines to other markets.

Other Energy Operations. We own six propane terminals, four asphalt terminals, seven refined product terminals and three lubricants blending and packaging facilities. We also own and lease a fleet of liquid and pressure trailers and tractors, which are used to transport refined fuels, propane, anhydrous ammonia and other products.

Products and Services

Our Energy segment produces and sells (primarily wholesale) gasoline, diesel fuel, propane, asphalt, lubricants and other related products and also provides transportation services. In addition to selling the products refined at our Laurel, Montana, and McPherson, Kansas refineries, we purchase refined petroleum products from third parties. For fiscal 2018, we obtained approximately 70% of the refined petroleum products we sold from our Laurel, Montana and McPherson, Kansas refineries, and approximately 30% from third parties.

Sales and Marketing; Customers

We market approximately 80% of our refined fuel products to members, with the balance sold to non-members. Sales are made wholesale to member cooperatives and through a network of independent retailers that operate convenience stores under the Cenex® trade name. We sold approximately 1.5 billion gallons of gasoline and approximately 1.7 billion gallons of diesel fuel in fiscal 2018. We also blend, package and wholesale auto and farm machinery lubricants to both members and non-members. We are one of the nation's largest propane wholesalers based on revenues. Most of the propane sold in rural areas is for heating and agricultural usage. Annual sales volumes of propane vary greatly depending on weather patterns and crop conditions.

Industry; Competition

The petroleum business is highly cyclical. Demand for crude oil and energy products is driven by the condition of local and worldwide economies, local and regional weather patterns and taxation relative to other energy sources, which can significantly affect the price of refined fuel products. Our Energy segment generally experiences higher volumes and profitability in certain operating areas, such as refined products, in the summer and early fall when gasoline and diesel fuel usage by our agricultural customers is highest and is subject to domestic supply and demand forces. Other energy products, such as propane, may experience higher volumes and profitability during the winter heating and crop drying seasons. More fuel-efficient equipment, reduced crop tillage, depressed prices for crops, weather conditions and government programs which encourage idle acres may all reduce demand for our energy products.

Regulation. Governmental regulations and policies, particularly in the areas of taxation, energy and the environment, have a significant impact on our Energy segment. Our Energy segment's operations are subject to laws and related regulations and rules designed to protect the environment that are administered by the Environmental Protection Agency (the "EPA"), the Department of Transportation (the "DOT") and similar government agencies. These laws, regulations and rules govern: the discharge of materials into the environment, air and water; reporting storage of hazardous wastes and other hazardous materials; the transportation, handling and disposal of wastes and other materials; the labeling of pesticides and similar substances; and investigation and remediation of releases of hazardous materials. Failure to comply with these laws, regulations and rules could subject us to administrative penalties, injunctive relief, civil remedies and possible recalls of products. Our hedging transactions and activities are subject to the rules and regulations of the exchanges we use, including the Chicago Mercantile Exchange (the "CME"), as well as the U.S. Commodity Futures Trading Commission (the "CFTC").

Competition. The petroleum refining and wholesale fuels business is very competitive. Among our competitors are some of the world's largest integrated petroleum companies, which have their own crude oil supplies, distribution and marketing systems. We also compete with smaller domestic refiners and marketers in the midwestern and northwestern United States, with foreign refiners who import products into the United States and with producers and marketers in other industries supplying other forms of energy and fuels to consumers. Given the commodity nature of the end products, profitability in the industry depends largely on margins, as well as operating efficiency, product mix and costs of product distribution and transportation. The retail gasoline market is highly competitive, with competitors that are much larger than us and that have greater brand recognition and distribution outlets throughout the country and the world than we do. We are also experiencing increased competition from regional and unbranded retailers. Our owned and non-owned retail outlets are located primarily in the northwestern, midwestern and southern United States.

We market refined fuel products in five principal geographic areas. The first area includes the Midwest and northern plains. Competition at the wholesale level in this area includes major oil companies as well as independent refiners and wholesale brokers/suppliers. This area has a robust spot market and is influenced by the large refinery center along the gulf coast.

To the east of the Midwest and northern plains is another unique marketing area. This area centers near Chicago, Illinois and includes eastern Wisconsin, Illinois and Indiana. In this area, we principally compete with the major oil companies as well as independent refineries and wholesale brokers/suppliers.

Another market area includes Arkansas, Missouri and the northern part of Texas. Competition in this area includes the major oil companies and independent refiners. This area is principally supplied from the Gulf Coast refinery center and is also driven by a strong spot market that reacts quickly to changes in the international and national supply balance.

Another geographic area includes Montana, western North Dakota, Wyoming, Utah, Idaho, Colorado and western South Dakota. Competition at the wholesale level in this area includes the major oil companies and independent refineries.

The last area includes much of Washington and Oregon. We compete with the major oil companies in this area. This area is known for volatile prices and an active spot market.

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AG

Overview

Our Ag segment includes our grain marketing, country operations, crop nutrients, processing and food ingredients and renewable fuels businesses. These businesses work together to facilitate the production, purchase, sale and eventual use of grain and other agricultural products within the United States, as well as internationally. In fiscal 2018, revenues in our Ag segment were $25.1 billion after elimination of intersegment revenues, consisting principally of grain sales.

Operations

Grain Marketing. We are the nation's largest cooperative marketer of grain and oilseed based on grain storage capacity and grain sales. Our grain marketing operations purchase grain directly from agricultural producers and elevator operators primarily in the midwestern and western United States and indirectly through our country operations business. The purchased grain is typically contracted for sale for future delivery at a specified location, and we are responsible for handling the grain and either arranging for or facilitation of its transportation to that location. We own and operate export terminals, river terminals and elevators throughout the United States to handle and transport grain and grain products. We also maintain locations in Europe, the Middle East, the Pacific Rim and South America for the marketing, merchandising and sourcing of grains and crop nutrients. We primarily conduct our grain marketing operations directly, but do conduct some of our operations through joint ventures, including TEMCO, LLC ("TEMCO"), a 50% joint venture with Cargill, Incorporated ("Cargill") focused on exports primarily to Asia.

Country Operations. Our country operations business operates 466 agri-operations locations through 44 business units dispersed throughout the midwestern and western United States. Most of these locations purchase grain from farmers and sell agronomy, energy, feed and seed products to those same producers and others, although not all locations provide every product and service. We also manufacture animal feed through eight owned plants and four limited liability companies and process sunflowers for human food and other uses.

Crop Nutrients. Our wholesale crop nutrients business delivers products directly to our customers and our country operations business from the manufacturer or through our 18 inland and river warehouse terminals and other non-owned storage facilities located throughout the United States. To supplement what is purchased domestically, our Galveston, Texas deep water port and terminal receives fertilizer by vessel from origins such as Asia and the Caribbean basin where significant volumes of urea are produced. The fertilizer is then shipped by rail to destinations within crop producing regions of the United States.

Processing and Food Ingredients. Our processing and food ingredients operations are conducted at facilities that can crush approximately 120 million bushels of oilseeds on an annual basis, producing approximately 2.7 million short tons of meal/flour and 1.5 billion pounds of edible oil annually. We purchase our oilseeds from members, other CHS businesses and third parties that have tightly integrated connections with our grain marketing operations and country operations business.