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Gross margins and cash flow sustainability

Parque Corporation applied to Fairview Bank early in 2005 for a $400,000 five-year loan to finance plant modernization. The company proposes that the loan be unsecured and repaid from future operating cash flows. In support of the loan application, Parque submitted an income statement for 2004. Prepared using the FIFO inventory cost flow approach, this income statement reflected annual profit that was approximately 50% of the principal amount of the loan. This was offered as evidence that the loan could easily be repaid within the five-year term.

Parque is in the business of recycling yelpin, an industrial lubricant. The company buys used yelpin from large salvage companies and, after cleaning and reconditioning it, sells it to manufacturing companies. The recycling business is very competitive and has typically generated small gross margins. The salvage companies set yelpin prices on the first day of each quarter, and Parque purchases yelpin at the established price for the entire quarter. Yelpin prices fluctuate with business conditions. Prices paid to salvage companies by Parque have risen in recent years but tend to fall during economic downturns.

Parque sells the recycled yelpin at $1 per pound above the currently prevailing price that it pays to acquire the used yelpin from salvage companies. December 31, 2003 inventory was 300,000 pounds at a cost of $7.00 per pound. Purchases and sales in 2004 were:

	Purchases	Sales
First quarter 2004	600,000 lbs. @ $7.20/lb.	700,000 lbs. @ $8.20/lb.
Second quarter 2004	700,000 lbs. @ $7.40/lb.	600,000 lbs. @ $8.40/lb.
Third quarter 2004	800,000 lbs. @ $7.80/lb.	700,000 lbs. @ $8.80/lb.
Fourth quarter 2004	600,000 lbs. @ $8.10/lb.	650,000 lbs. @ $9.10/lb.

Cash operating costs during 2004 totaled $2,800,000.

Required:

1. Compute 2004 income for Parque Corporation using the FIFO inventory flow assumption. Ignore income taxes.
2. Did Parque Corporation really earn a profit from its *operating* activities in 2004?
3. Given the circumstances described, what risks exist that could threaten ultimate repayment of the loan?