Question CPA-00285

Plack Co. purchased 10,000 shares (2% ownership) of Ty Corp. on February 14, Year 1. Plack received a stock dividend of 2,000 shares on April 30, Year 1, when the market value per share was $35. Ty paid a cash dividend of $2 per share on December 15, Year 1. In its Year 1 income statement, what amount should Plack report as dividend income?

a. $20,000
b. $24,000
c. $90,000
d. $94,000

Explanation

Choice "b" is correct.

Dividend income = Number of shares × dividend per share
= 12,000 × $2
= $24,000

Receipt of a stock dividend is not revenue. It increases the number of shares held and decreases the cost basis per share.

Question CPA-00286

Pal Corp.'s Year 1 dividend income included only part of the dividend received from its Ima Corp. investment. The balance of the dividend reduced Pal's carrying amount for its Ima investment. This reflects that Pal accounts for its Ima investment by the:

a. Cost method, and only a portion of Ima's Year 1 dividends represent Pal's earnings after Pal's acquisition.
b. Cost method, and its carrying amount exceeded the proportionate share of Ima's market value.
c. Equity method, and Ima incurred a loss in Year 1.
d. Equity method, and its carrying amount exceeded the proportionate share of Ima's market value.

Explanation

Choice "a" is correct. The facts indicate a portion of the dividends were considered income and a portion a return of capital. This implies the cost method and dividends in excess of earnings.

Rule: Under the cost method, dividends (not earnings) are reflected as income by the investor. The cost basis investment account is reduced only if:

1. Shares of stock are sold, or
2. Cumulative dividends exceed cumulative earnings (a return of capital), or
3. Subsidiary incurs losses that substantially reduced net worth.

Choice "b" is incorrect. Cost method investments are not adjusted for changes in market value but that does not explain the portion of the dividend not recognized in income.

Choice "c" is incorrect. Under the equity method, 100% of the dividends paid would reduce the investment account.

Choice "d" is incorrect. 100% of the dividends are considered a reduction of the investment account under all circumstances when using the equity method.

Question CPA-00287

An investor uses the cost method to account for an investment in common stock. Dividends received this year exceeded the investor's share of investee's undistributed earnings since the date of investment. The amount of dividend revenue that should be reported in the investor's income statement for this year would be:

a. The portion of the dividends received this year that were in excess of the investor's share of investee's undistributed earnings since the date of investment.
b. The portion of the dividends received this year that were not in excess of the investor's share of investee's undistributed earnings since the date of investment.
c. The total amount of dividends received this year.
d. Zero.

Explanation

Choice "b" is correct, the amount of dividend revenue that should be reported in the investor's income statement for this year would be the portion of the dividends received this year that were not in excess of the investor's share of investee's undistributed earnings since the date of investment.

Rule: Dividend revenue - under the cost method should be recognized to the extent of cumulative earnings since acquisition, and return of capital beyond that point.

Choice "a" is incorrect. This will be characterized as a return of capital or liquidating dividend.

Choices "c" and "d" are incorrect. Part of the dividends will be recognized as income and part will be a return of capital.