FINANCE AT A GLANCE

What are contra accounts?

Lesson 53

So far we have presented five types of accounts: assets, liabilities, equity, revenues and expenses. There is a sixth type of account. They are the so-called ***contra accounts.*** We need to know what they are before we carry on with our walk through the accounting cycle. A contra account is an account that appears in the balance sheet as a reduction in the value of an asset or liability to which it is associated. A contra account is neither an asset nor a liability, but an adjustment to a main asset or main liability account. A contra account that is associated with an asset is called a contra asset. Examples of contra accounts are *Accumulated depreciation* and *Allowance for doubtful accounts.*

Fixed assets	200,000
Less: Accumulated depreciation	-80,000
Net fixed assets	120,000
Accounts receivables	80,000
Less: Allowance for doubtful accounts	5,000
Accounts receivables, net	75,000

The accounting entries of a contra asset behave in the opposite way as those of an asset. An increase in a contra asset is a credit entry, and a decrease is a debit entry.

A contra account that is associated with a liability is called a *contra liability*. An example is a *Bond discount*, which reduces the value of a liability in the form of bonds. We will not go into this now. Let it suffice to say that the entries of a contra liability behave in the opposite way as those of a liability. An increase in a contra liability is a debit entry, and a decrease is a credit entry.

As far as contra accounts are concerned, we are only after the clarification of a contra asset called Accumulated depreciation, which we will need in our continuing discussion of the accounting cycle.

In simple terms, *Depreciation* is the reduction in the value of an asset due to usage, passage of time, wear and tear, technological obsolescence, etc.

Depreciation is, in effect, an expense ascribable to a given period of time. Instead of reducing the value of the asset by the amount of depreciation expense for the period, this reduction in value is accumulated from period to period, and is presented in the balance sheet as Accumulated depreciation. For example, take the case of a manufacturing equipment which costs $200,000 on acquisition , and which has an expected life of 5 years. If we assume that the amount of wear and tear is uniform over the expected life, then the depreciation expense is $40,000 per year (which is based on $200,000 divided by 5). After 2 years of operation, the Accumulated depreciation amounts to $80,000 (which is based on $40,000 per year times 2 years).

You will notice that in Lesson 41, we recorded the acquisition of fixed as assets as a debit to Net fixed assets (which is the Fixed assets less Accumulated depreciation). That was just a shortcut for illustrative purposes. In practice, acquisition of fixed assets is recorded as a debit to Fixed assets, as we did in Lesson 45.)