



# Share-based payments

A guide to expense accounting and reporting

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## Introduction

From salaries and insurance to office rent and equipment, there are numerous costs associated with running a business that must be reported. What many startups don't realise, however, is that equity awards should also be included in their expense reports. This is because awarding equity to employees or investors represents the transfer of implicit value, which may increase over time as the company grows.

Accounting for equity-related expenses (otherwise known as "share-based payments") is a complex task, and getting it right is crucial if you want to build confidence with investors and ensure your company is audit-ready. This guide combines expert insights with worked examples to help you understand how expense reporting works and why it matters.

## Glossary

We've defined some of the key terms used in this guide. For a more comprehensive list, see our [equity glossary](#).

| Term                           | Definition   |
|--------------------------------|--|
| <b>Amortization method</b>     | An accounting technique used to spread the cost of an asset over a period of time. The three standard methods are graded, straight-line and ratable amortization.  |
| <b>Expense reporting</b>       | The process of tracking and accounting for all the expenses that affect a company's financial position (e.g. office rent, utilities, salaries and share-based payments). Also known as expense accounting, it is a subset of <a href="#">financial reporting</a> . |
| <b>Fair market value (FMV)</b> | The estimated price an asset would fetch in an open and unrestricted market, when the buyer (e.g. an employee) and the seller (e.g. a company) have reasonable knowledge of relevant facts. It is the standard value used for income tax purposes.                 |
| <b>FRS 102</b>                 | The financial reporting standard within UK GAAP. It is the equivalent of <a href="#">ASC 718</a> under US GAAP.  |

|   |  |
|---|--|
| <b>Generally Accepted Accounting Principles (GAAP)</b>    | An accounting standard used in some countries, with regional variations. US GAAP is the default for US businesses, while some companies in the UK follow UK GAAP.                                      |
| <b>Income statement</b>                                   | A financial report outlining a company's income and expenditure over a set period of time (e.g. a fiscal year or a quarter). Sometimes called a profit and loss (P&L) statement.                       |
| <b>International Financial Reporting Standards (IFRS)</b> | The common accounting language used across Europe and in 167 jurisdictions worldwide.  |
| <b>IFRS 2</b>   | A share-based payment standard that applies to companies following IFRS. It was issued by the International Accounting Standards Board in 2004.  |
| <b>Option fair value</b>                                  | The price at which company shares could be bought or sold between willing parties (i.e. not in a forced or liquidation sale). Determined using an option pricing model, such as <u>Black-Scholes</u> . |
| <b>Risk-free rate of return</b>                           | The expected return from a zero-risk investment. This rate is theoretical, since no investment is entirely without risk.   |
| <b>Share-based payment</b>                                | A transaction that occurs when an entity offers equity instruments, other assets or a cash equivalent (based on the value of its equity) to a third party in exchange for goods or services.           |
| <b>Share-based payment reporting</b>                      | The process of calculating and reporting on the value of share-based payments (e.g. share option grants) made to employees.  |

# Reporting requirements

## Why is expense reporting important?

From a compliance perspective, expense reporting isn't just important; it's essential. In accordance with IFRS 2 and FRS 102, companies are required to recognise share-based payment transactions – and the associated expenses – in their financial statements.

As a measure of financial health, expense accounting can also affect your chances of securing venture capital funding. Prospective investors may ask to see historical and recent reports before deciding whether to invest, so keeping track of share-based payments from an early stage will set you up for success in the future.

## Which companies need to report share-based payments?

Technically, expense reporting applies to all companies. In practice, however, some startups don't start accounting for share-based payments until they've passed the threshold for audit exemption (i.e. until there's a risk of being penalised). These thresholds vary across Europe; in the UK, companies with an annual turnover exceeding £10.2 million, total assets worth more than £5.1 million and over 50 employees are likely to be audited.

Generally, it's best to get into the habit of tracking all transactions and updates to awards as early as possible – ideally after issuing your first equity grant. This will make it easier to prepare accurate, audit-ready expense reports as your business grows and the transactions become more complex.

## How often should share-based payments be reported?

Limited companies in the UK are required to include share-based payments in their annual income statement. This statement forms part of a company's statutory accounts, which must be filed with Companies House and HMRC at the end of every financial year.

Share-based payments reporting is also a requirement for companies based elsewhere that follow IFRS, such as European businesses. The rules and deadlines for submitting financial statements vary for different jurisdictions, so check with your local tax authority.

You may need to generate expense reports more often than once a year. For instance, if you're preparing for a material event (e.g. a funding round, IPO, merger or acquisition), financial reporting is likely to be part of the due diligence process. Some investors also expect to receive this information from their portfolio companies on a quarterly basis.

## Calculating share-based payment expenses

The total expense of an equity award is usually calculated by feeding various data points into an option pricing model. Black-Scholes is the simplest and most widely used model, whereas Monte Carlo and the binomial model offer greater flexibility when handling complex variables and future outcomes. Despite their differences, each model relies on the same inputs:

- **Fair market value (FMV)** – the value of the underlying share class associated with an equity award, as determined by a company valuation
- **Strike price** – often equal to the FMV of the relevant share class (typically ordinary shares) for standard option grants
- **Expected term of the grant** – represents the time an award is expected to be outstanding. For companies without sufficient historical data, it can be estimated using the vesting schedule, the contractual life of the award or an average of both
- **Interest rate** – typically calculated using the risk-free rate of return for a specific country, as of the grant date
- **Market volatility** – based on historical and predicted fluctuations in share price. This is sometimes difficult to determine for private companies, so the data from comparable public companies can be used to calculate an estimated volatility
- **Dividend yield** – used as an additional input when calculating equity expenses for public companies

After calculating the expense incurred by a share-based payment, you need to understand when to recognise that expense. This involves using an accounting technique called amortization, which spreads the cost of an asset over a specific period of time.

### Amortization methods

Amortization works by splitting an outstanding equity award into separate tranches according to its vesting schedule. For instance, a grant that vests 25% every year over a four-year period would have four equal tranches. How the expense of an award is distributed across each tranche depends on which amortization method you use: graded, straight-line or ratable.

### Graded amortization

Sometimes referred to as the “FIN 28” or “accelerated” method, graded amortization treats the tranches as separate awards that start vesting at the same time. The fair value of each tranche is recognised from the initial grant date of the entire award to the vesting date of that specific tranche.

Imagine you’ve issued share options with a typical four-year vesting schedule. As illustrated in the table below, the overall expense is front-loaded or accelerated. This increases both the likelihood and the difficulty of reversing an expense – for example, if an employee leaves before all their options have vested – because you’ve already accounted for the expense in future tranches.

| Tranche             | Percentage of expense recognised each year |            |            |           |
|---------------------|--|------------|------------|-----------|
|                     | Year 1                                     | Year 2     | Year 3     | Year 4    |
| 1                   | 100%                                       | 0%         | 0%         | 0%        |
| 2                   | 50%  | 50%        | 0%         | 0%        |
| 3                   | 33%  | 33%        | 34%        | 0%        |
| 4                   | 25%  | 25%        | 25%        | 25%       |
| <b>Entire award</b> | <b>52%</b>                                 | <b>27%</b> | <b>15%</b> | <b>6%</b> |

### Straight-line amortization

The straight-line method spreads the fair value of an award evenly over the total requisite service period (i.e. from the initial grant date to the final vesting date of the last tranche). The expense for each tranche is based on the number of days of vesting, so the annual cost is the same regardless of tranche size. For grants with a standard four-year vesting schedule, 25% of the overall expense is recognised each year.

### Ratable amortization

With ratable amortization, each tranche is considered on an individual basis. This results in a staggered expense distribution based on the number of share options in each tranche. If the tranches are equally weighted, the ratable method produces a similar result to straight-line amortization. However, if more share options vest in the first tranche, the expense will be higher in the first year than the following years.

## Worked example

You grant 1000 share options to a new joiner on 1 January 2020. The award vests annually over a four-year period and has an option fair value of £1.00 per share. How would you recognise the total expense as of 31 December 2021?

a) Using straight-line amortization

|              | 31/12/2020     | 31/12/2021     | 31/12/2022     | 31/12/2023     | Total            |
|--------------|----------------|----------------|----------------|----------------|------------------|
| Tranche 1    | £250.00        | £0.00          | £0.00          | £0.00          | £250.00          |
| Tranche 2    | £0.00          | £250.00        | £0.00          | £0.00          | £250.00          |
| Tranche 3    | £0.00          | £0.00          | £250.00        | £0.00          | £250.00          |
| Tranche 4    | £0.00          | £0.00          | £0.00          | £250.00        | £250.00          |
| <b>Total</b> | <b>£250.00</b> | <b>£250.00</b> | <b>£250.00</b> | <b>£250.00</b> | <b>£1,000.00</b> |

Total expense recognised as of 31/12/2021:  
 $£250.00 + £250.00 = \mathbf{£500.00}$

b) Using graded amortization

|                     | 31/12/2020     | 31/12/2021     | 31/12/2022     | 31/12/2023    | Total           |
|---------------------|----------------|----------------|----------------|---------------|-----------------|
| Tranche 1           | £250.00        | £0.00          | £0.00          | £0.00         | £250.00         |
| Tranche 2           | £125.00        | £125.00        | £0.00          | £0.00         | £250.00         |
| Tranche 3           | £83.33         | £83.33         | £83.34         | £0.00         | £250.00         |
| Tranche 4           | £62.50         | £62.50         | £62.50         | £62.50        | £250.00         |
| <b>Entire award</b> | <b>£520.83</b> | <b>£270.83</b> | <b>£145.84</b> | <b>£62.50</b> | <b>£1000.00</b> |

Total expense recognised as of 31/12/2021:  
 $£520.83 + £270.83 = \mathbf{£791.66}$

## Accounting standards

The method you use to calculate and distribute share-based payment expenses should align with the accounting standard your company follows:

- **Graded amortization** is required for IFRS and is the preferred method under UK GAAP. It's also recommended for equity awards with a performance-based or front-loaded vesting schedule
- **Straight-line amortization** is mostly used in the United States because it complies with US GAAP
- **Ratable amortization** is the least common method, despite being accepted by both IFRS and GAAP

When it comes to choosing an accounting standard, there are no formal rules; this decision will largely depend on the location and makeup of your company. For instance, if the majority of your employees are based in one country, you might want to follow the local Generally Accepted Accounting Principles (e.g. US GAAP or UK GAAP). Conversely, if you have a broader stakeholder base, the International Financial Reporting Standards (IFRS) might be a better fit.

As your business scales up, there's a chance you'll need to adopt a different amortization method that can handle more complex transactions, such as awards settled in cash. Although switching methods is possible, it can involve a lot of work – especially if you have to recalculate past expenses. Following best practices and working with a financial reporting expert from an early stage could save you a lot of time and hassle in the long run.

## The audit process

In the event of an audit – which is more likely as your company grows and passes the exemption threshold – your annual accounts will be inspected for accuracy. Knowing what to expect from the process allows you to prepare in advance and prevent costly mistakes.

### What happens during an audit

You'll need to show that all share-based payment expenses have been recorded correctly on your income statements. You may also need to justify the inputs and methods used to calculate each expense.

Our financial reporting team has helped Carta customers answer a variety of questions from auditors, such as:

- Can you confirm which interest rate you used? What was the source?
- Is the expected term of each grant always 10 years? How was it determined?
- Where did you source the peer data from? How was it used to calculate volatility?

Any errors found in your share-based payment records could delay the audit process and incur additional fees. Not only would your income statements need correcting, but the auditors might decide to check other areas of your accounting more thoroughly.

### Common mistakes to avoid

Unsurprisingly, the most difficult areas of expense reporting are the most error-prone. Many companies make mistakes when handling complex transactions like exercises or forfeitures (i.e. lapsed or cancelled grants). There's a common misconception that, when an employee leaves, the expense associated with all their options should be reversed. However, this is only true for *unvested* options. IFRS 2 requires the expense of any *vested* options (exercised or not) to be recognised, even if the award has been cancelled.

Calculating the total expense of an equity award can also cause confusion. Some of the inputs used in the Black-Scholes model are time-sensitive – especially the FMV of the underlying share class, interest rate and market volatility. It's important to value each award as of the grant date, which is why you need an up-to-date valuation before issuing equity.

Arguably the biggest oversight is waiting until an audit to start accounting for share-based payments, which often results in rushed and inaccurate reports. Tracking expenses as you go is easier – and less costly – than trying to backdate calculations or rectify mistakes.



# Expense reporting from Carta

Manually calculating your share-based payment expenses can be time-consuming, inaccurate and costly, especially as your company grows.

With Carta, expense reporting is one less thing to worry about. Our in-house experts leverage your cap table data to deliver fast, comprehensive and trustworthy reports that comply with the accounting standard your company follows. They're on hand to answer any questions from authorities and support you in the event of an audit.

## How does it work?

- 1 Sign up for a Carta Scale subscription and complete the onboarding process
- 2 Request a share-based payment report through the platform, as often as you need
- 3 Meet with our financial reporting team to discuss your details and requirements
- 4 Review your report once it's ready, and request any further updates or changes
- 5 Approve the final report and file it with your local tax authority



Single source of truth



Certified in-house experts



Straightforward pricing



**Ryan Turley**  
Financial Reporting Lead

To find out how Carta can support your company, contact [ryan.turley@carta.com](mailto:ryan.turley@carta.com) or book a [free expert consultation](#).

*“Ryan is amazing at what he does. Efficient and a great communicator.”*

- Ryan Horwood, FitXR