

carta

Startup Guide to Expensing Employee Options

Is your startup staying compliant? Learn how to expense employee stock options using ASC 718 accounting guidelines.



In this guide, you'll learn everything you need to know about expensing employee options under Accounting Standards Codification, Topic 718 (ASC718).

Many companies, especially technology startups, offer stock options and other forms of company ownership to employees as part of their overall compensation package.

These equity awards have obvious benefits for companies—they help them attract talent, lower their cash salary requirements, align incentives between employee and company, and encourage longer tenures.

But offering stock-based compensation can come at a price, too. Just like a cash salary, stock-based compensation is an operating expense and must be recorded in the company's financial statements.

As a company grows or receives more funding, institutional investors will expect those statements to have an accurate accounting on the expensing of employee options. It's a sign that your company is well-managed—and that you won't be facing messy audits or even penalties.

HOW CARTA HELPS SIMPLIFY EXPENSING

Your cap table changes constantly, but Carta automatically tracks all those changes for you—from grant and vesting statuses, to terminations, and cancellations for equity grants.

The Carta Financial Reporting software suite automates the application of complicated accounting guidance and transfers relevant information from your cap table into a Microsoft Excel report.

Carta Financial Reporting will:

1. Determine the total fair value for your company's stock options and restricted stock
2. Calculate the amount of expense that should be recognized within a specific reporting period
3. Provide support for financial statement footnotes relevant to equity awards

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Why does equity need to be expensed?

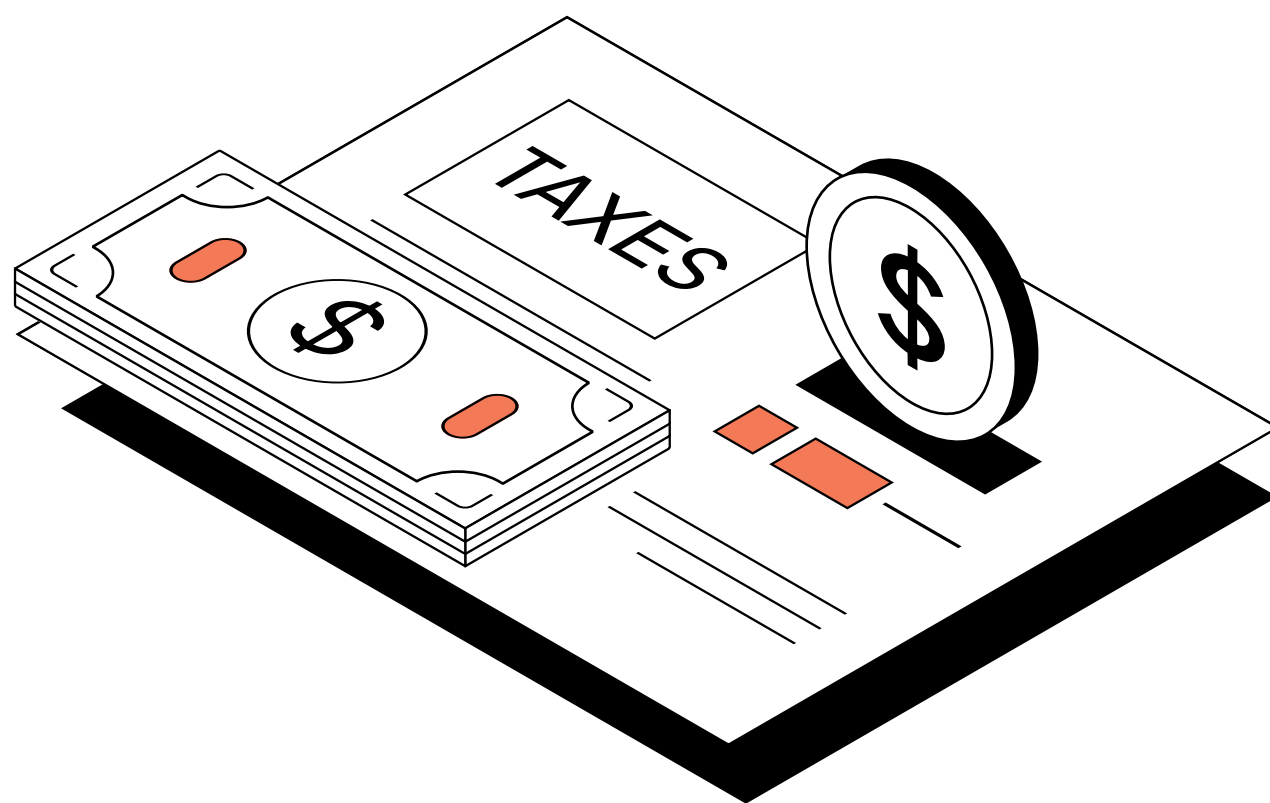
Companies issue equity awards in exchange for services from their employees, which in turn help generate revenue. To recognize this revenue, your company should "expense" the equity awards on its income statement.

[Read more about deferred tax assets →](#)

What if I don't expense equity awards?

If companies don't recognize the expense of equity awards on their income statements, profits would be inflated by assuming employees provided services to the company for free. Companies may also need to track the tax consequences of these awards.

In order to properly expense options, it's necessary to determine the implied value of the equity award. This is done through determining the fair value.



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How to calculate fair value

The **fair value** of an award is the monetary value of the award in dollars. Equity, especially for private companies, is not liquid and not publicly traded. Therefore, it's difficult to determine what the dollar value of the equity is and how much the company should recognize as expense on its financials.

The solution is to use an option-pricing model to determine the value of stock options and a [409A valuation](#) to determine the value of restricted stock.

For stock options

Carta uses the **Black-Scholes** option pricing model within its reports, as prescribed by the guidance. The model prices options contracts for the most common forms of corporate equity: **non-qualified stock options (NSOs)** and **incentive stock options (ISOs)**.

For restricted stock

Restricted stock units (RSUs) and **restricted stock awards (RSAs)** are those in which the underlying shares are issued to the recipients usually at no cost; it is not necessary to apply an option-pricing model. The value can be determined by a **409A valuation**—a third-party assessment of a company's value.

HOW CARTA HELPS

While Black-Scholes is a standardized mathematical equation, Carta's Financial Reporting tool automates the calculation of the fair value inputs using the award details on the cap table and the report settings. To ensure a proper valuation, the cap table and its settings must be up to date.

Carta's reporting recognizes the total fair value of all stock options and restricted stock.

Step-by-step: Calculating fair value

Stock options

- 1 Determine award attributions
- 2 Apply Black-Scholes option pricing model
- 3 Fair value of stock options
- 4 Total fair value of stock options

Restricted stock

- 1 Determine value of common stock
- 2 Subtract any cash paid by stakeholder
- 3 Fair value of restricted stock
- 4 Total fair value of restricted stock

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Recognizing expense over time: Service periods and vesting

Correctly interpreting ASC 718 and creating accurate and complete financial reports depends on properly expensing options that are granted over time, not all at once.

Similar to the annual cash salary promised in an offer letter, companies do not recognize the entire compensation expense up front, but throughout the period in which it is earned by the employees as they provide service to the company. This is also called **vesting**.

Generally, equity awards vest over time in multiple tranches—for example, an employee may earn 25% of the overall equity compensation in year one, another 25% in year two, and so on, until the entire award is vested at the end of year four.

The period during which an employee is receiving stock-based compensation, typically from the initial grant date through the final vest date, is called the **service period**, and each vesting event—for example, the first options award that occurs after one year of employment—is called a **tranche**. Stock-based compensation expense is recognized throughout an individual service period and is based on the amount that is vested.

Keeping track of all this can be extremely challenging, particularly given the guidance accounting has strict rules about making sure a minimum amount of expense is reported each period (referred to as the floor concept, it ensures that vested shares as a minimum are expensed each period).



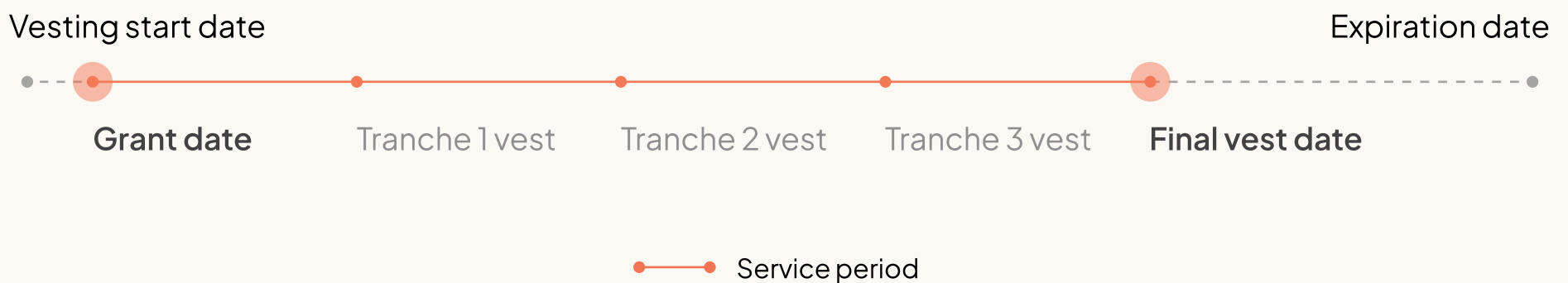
KEY CONSIDERATION

If an unvested equity award is forfeited due to a termination of service, the service period would shorten to only the portion that was vested/earned (see more in the forfeiture section of this guide).

HOW CARTA HELPS

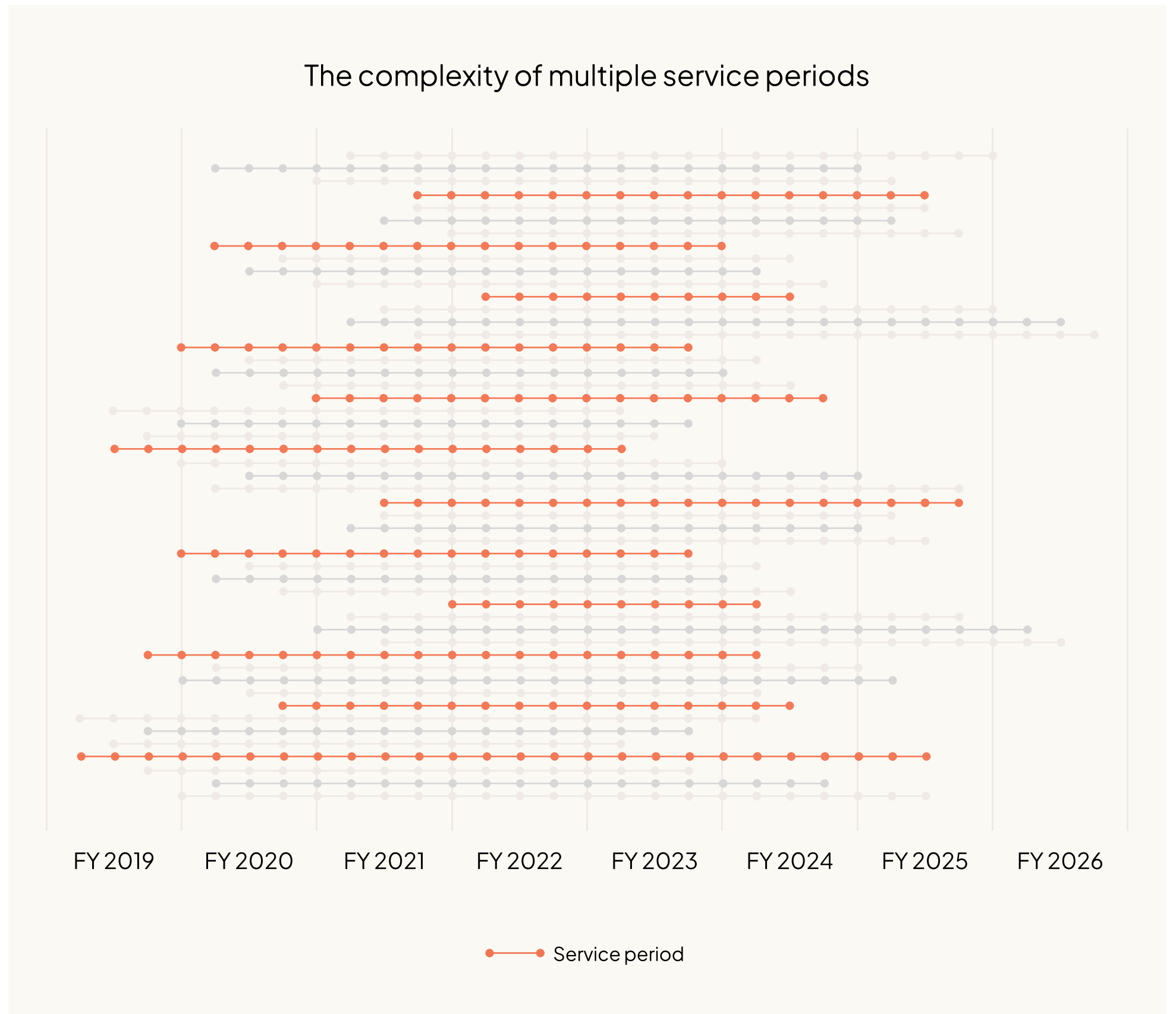
Carta assigns a service period for each tranche and recognizes expense accordingly depending on how many service days have been provided to the company to earn each tranche.

Service period of an equity grant



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The service period of an equity grant chart shows an equity grant to just one employee, but every equity grant may have a different service period, with different grant dates and vest dates. As you can imagine, this will result in hundreds or thousands of unique service periods across all awards that need to be tracked (as shown in the chart below):



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What are reporting periods?

In contrast to a service period, which tracks an individual equity grant’s life from beginning to end, a reporting period is the view of a company’s stock compensation expense for all equity tranches for a specific period of time. It lines up with the reporting periods that are used for the company’s financial statements. Carta Financial Reporting helps de-code complex service reporting into streamlined reporting periods.

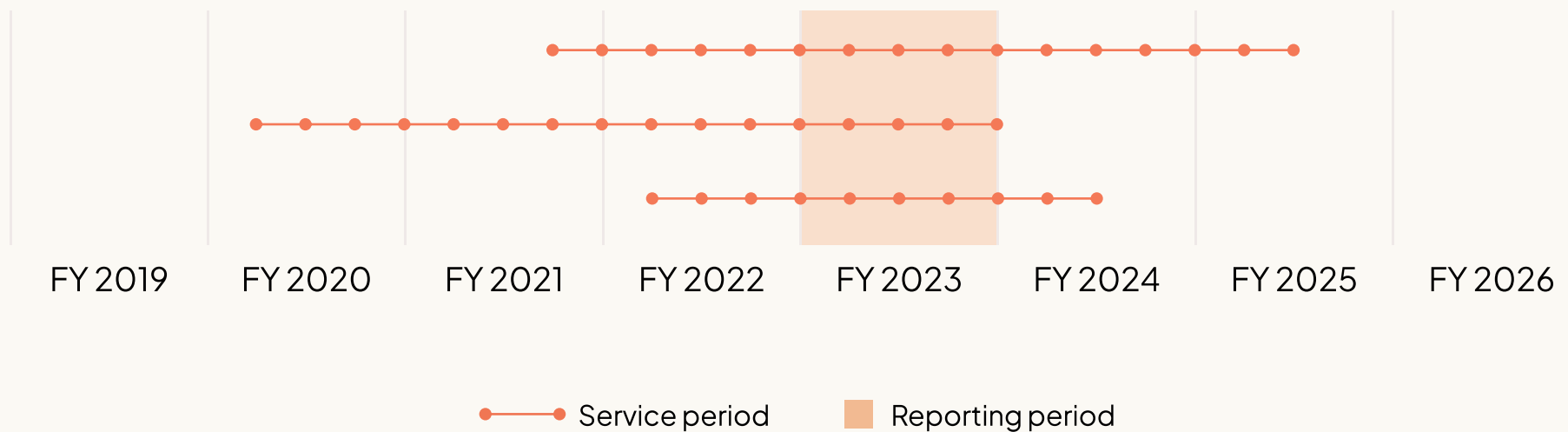
For example, a company may decide to have a reporting period for the full year (as opposed to breaking down into quarters or monthly); this would include any tranches that occurred during that year, which would typically represent partial service periods, since most service periods are longer than one year.



KEY CONSIDERATION

Reporting periods must “line up” so that there is no gap in between them. This is to ensure that no grant activity is double-counted or missed. When properly handled in this way, the amount of expense recognized and the option activity within a reporting period can easily be derived from what was recorded in the prior reporting period.

Reporting periods capture a slice of service periods



In addition to showing the expense, companies must provide a series of disclosures, required under ASC 718 and International Financial Reporting Standards Standards (IFRS 2), for each reporting period. The disclosures include a summary of active grants during that reporting period, including the option activity for that period such as the amount granted, exercised, forfeited, expired, and vested.

Typically, when a period is “closed,” it is considered final and does not change. Prior period adjustments made after the reporting period is closed will be accounted for in the subsequent reporting period instead.

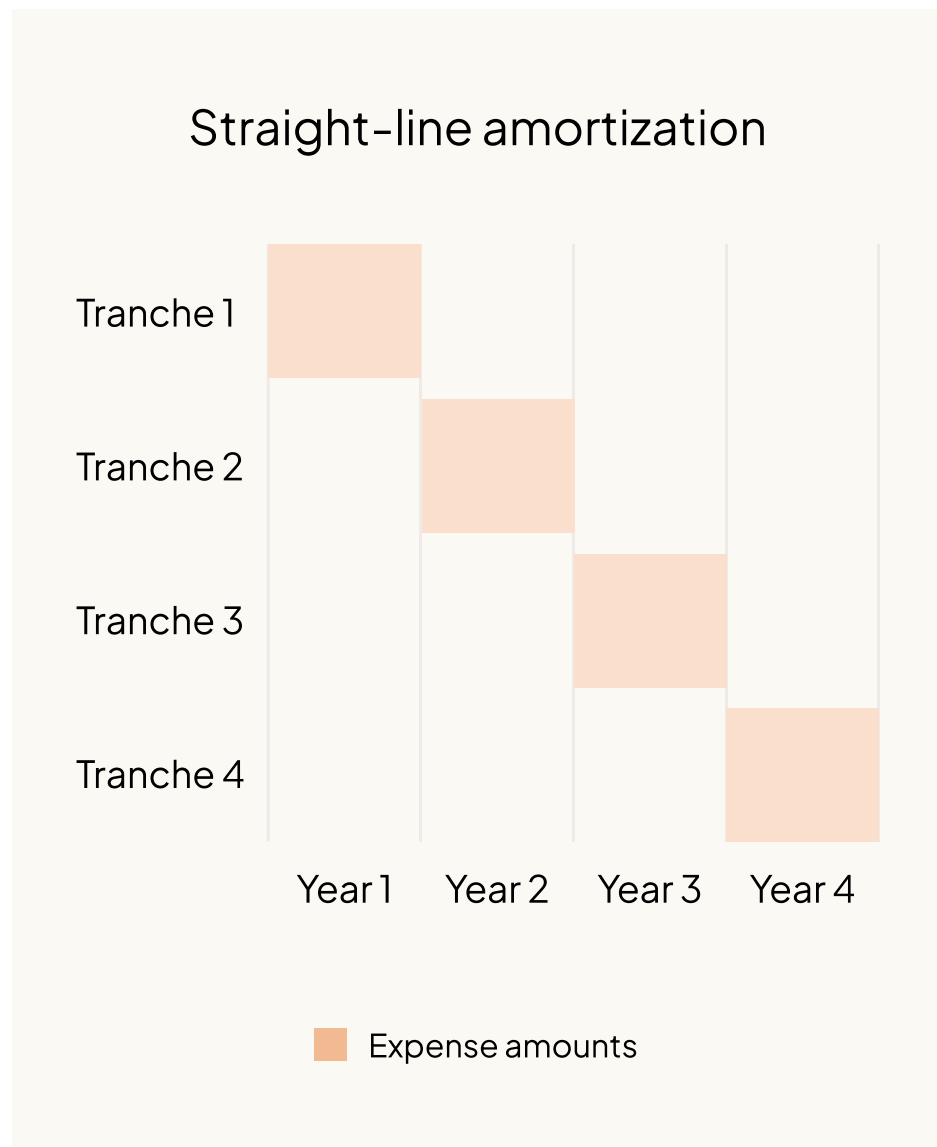
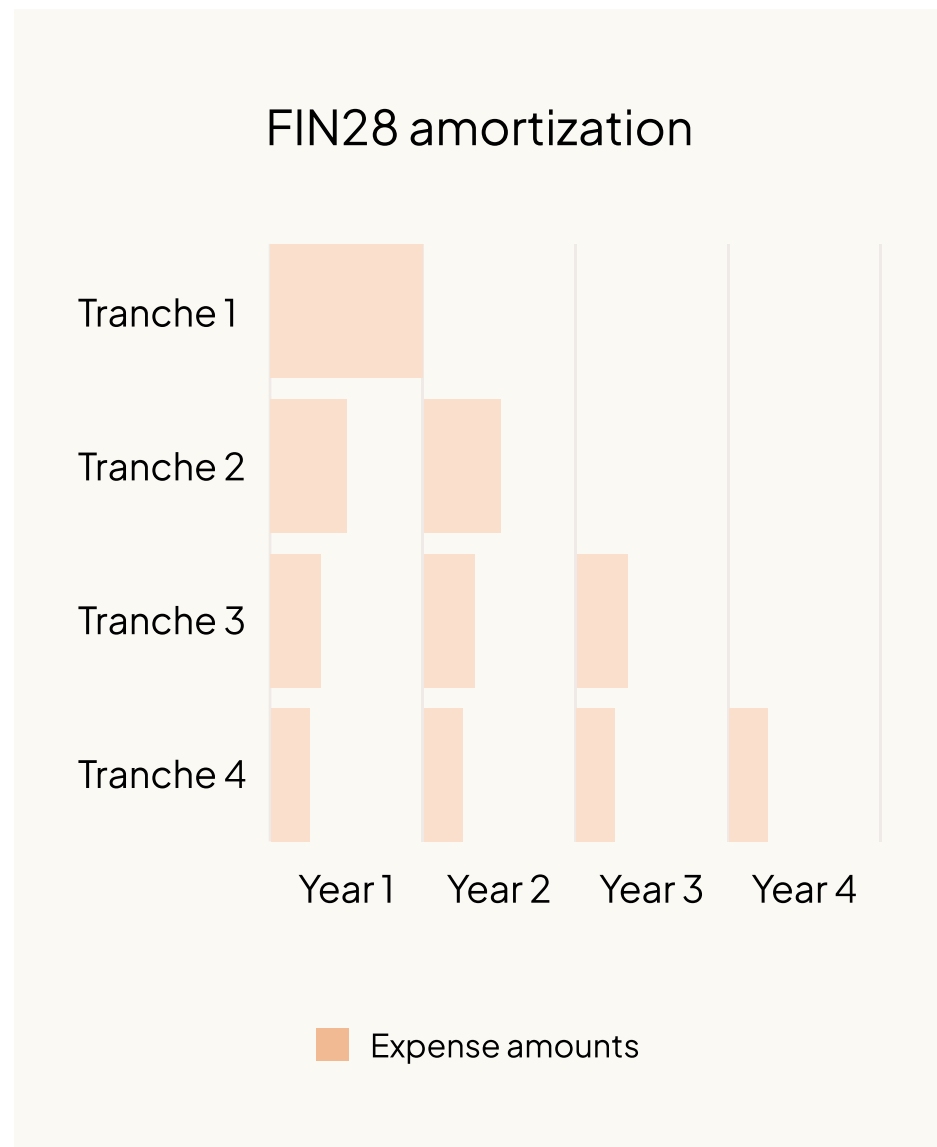
HOW CARTA HELPS

As part of its Financial Reporting software, Carta issues reports capturing the total stock compensation expense and the required minimum disclosures for the reporting period.

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Amortization methods

When an employee receives an award that vests across multiple tranches, it's necessary to use an amortization method to determine how much of their overall equity award a recipient has earned over time. Carta supports both of the two primary methods—FIN28 (or commonly referred to as 'graded') and the straight-line method.



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How Carta calculates expense

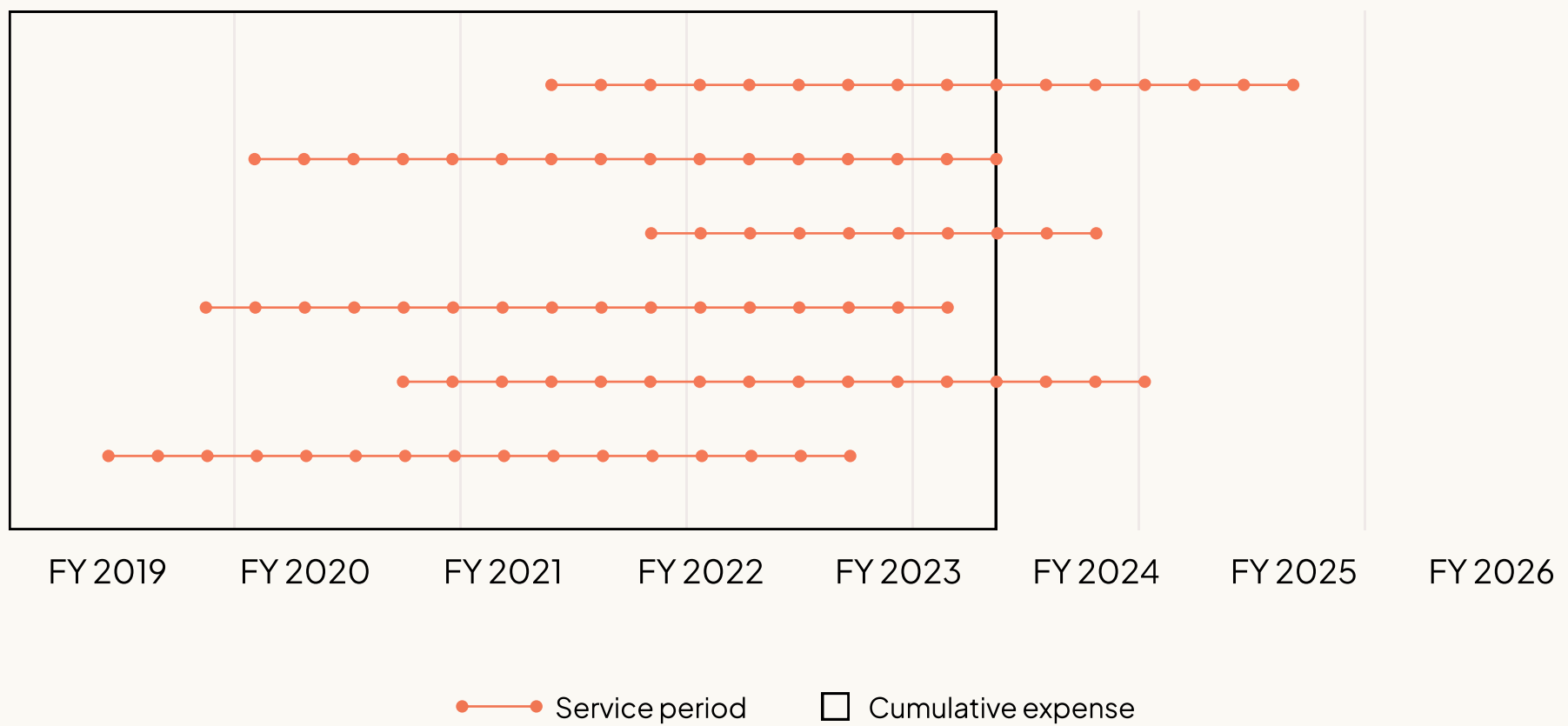
To determine the amount of compensation expense within a specific reporting period, each reporting period first determines the cumulative amount of expense that should be recognized. This considers all the latest updates to the cap table including:

- New awards
- Terminations
- Cancellations
- Modifications
- Performance conditions
- Forfeiture rates



$$\text{Total fair value} \times \text{Percentage of service completed} = \text{Cumulative expense to date}$$

Cumulative expense reporting



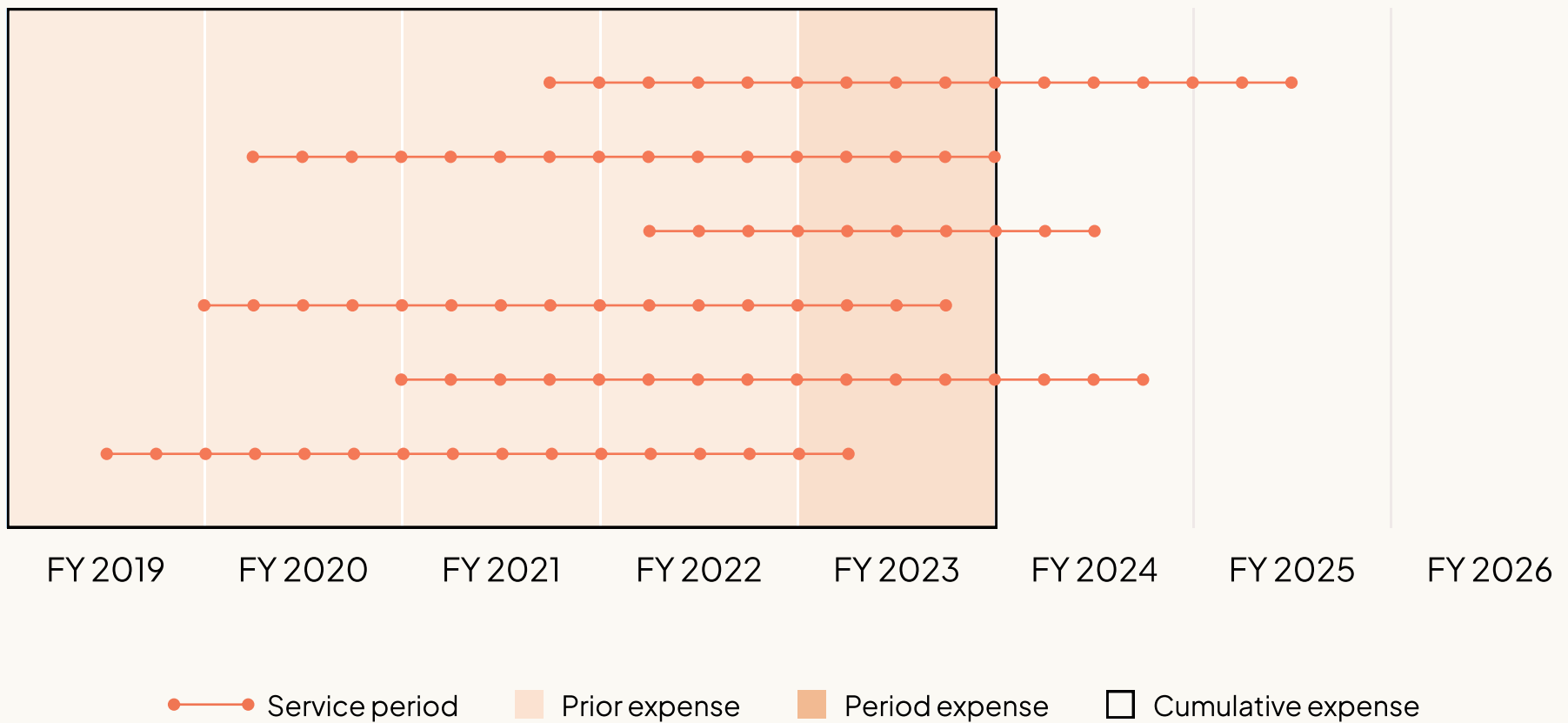
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After your very first expense report, each subsequent report for your company is built upon the last one. That means the current period expense can be calculated by subtracting the previous period's expense from the new report's cumulative expense to date. Here's how the formula looks:



$$\text{Cumulative expense to date} - \text{Prior period expense to date} = \text{Period expense}$$

Cumulative expense reporting



HOW CARTA HELPS

Using this cumulative expense process, Carta ensures that any activity not captured in the previous period is brought up to date in the subsequent period.

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Forfeitures in cases of employee termination

If an employee's service is terminated, your company will recognize the expense for what has been earned or vested by the employee through their services to the company. Your company will not need to recognize expense for what is forfeited or unvested due to a termination of service.

In general, each reporting period will accrue expense for service provided and when vesting is probable. Upon a termination of service, Carta will reverse any accrued expense on the portion that has been forfeited in which vesting is no longer probable.



[Read more about forfeitures](#) →



KEY CONSIDERATION

Remember: Stock options are compensation (exercised or not)

Companies must expense options granted to employees, and cannot reverse that expense later if vested options are not exercised.

This is similar to how a cash salary is viewed—companies would not ask an employee to give back cash for the services the employee already provided. The company has received the services and the employee has earned their salary.

In the same way, stock options are compensation given to the employee, exercised or not, and the company would not ask the employee to give the options back. Therefore, the company does not reverse the expense related to the equity the employee earned.

Estimating for forfeitures

In most cases, employees won't earn the entire equity grant promised to them upon joining the company. A typical vesting schedule is four years, while the average tenure of an employee is under three years.

Historically, companies were required to estimate a forfeiture rate to avoid overreporting future expenses. This was performed by applying a forfeiture rate to determine the amount of shares out of the total that were expected to vest and only recognize expense on that portion. The challenge is that new companies often do not have enough forfeiture history to accurately estimate future forfeitures and the amount of shares that are expected to vest.

The Financial Accounting Standards Board (FASB) addressed this with the additional guidance provided by an Accounting Standards Update (ASU 2016-09) that removed the requirement of a forfeiture rate and allowed companies to simply account for forfeitures when they occur, which is currently the standard practice for private companies.

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Companies that wish to account for forfeitures as they occur may simply estimate a 0% forfeiture rate, which would assume that 100% of the award is expected to vest.

It's important to note that calculating forfeitures applies only to options which did not vest—for example, when an employee leaves the company prior to all options vesting.

This does NOT apply to vested shares that employees do not exercise. For stock options, the actual compensation to the employee is the ability to exercise a stock option, which occurs at vesting, and not the exercise itself. Therefore, regardless of whether the employee exercises the option or not, the company does not reverse expense for vested stock options.

HOW CARTA HELPS

Companies who wish to calculate forfeiture rates can edit this section in their Carta dashboard::

SCENARIO

Default settings

Reports FVA Methodology FRVs Performance awards **Forfeiture rates** Volatility Cancellations

Enter current and historical forfeiture rates with their effective dates. You must have a forfeiture rate on or before your earliest issue date.

<p>Effective date</p> <div style="border: 1px solid #ccc; border-radius: 5px; padding: 5px; display: flex; align-items: center;"> 📅 <input style="flex-grow: 1; border: none;" type="text" value="01.01.20"/> </div>	<p>Forfeiture rate</p> <div style="border: 1px solid #ccc; border-radius: 5px; padding: 5px; display: flex; align-items: center;"> % <input style="flex-grow: 1; border: none;" type="text" value="0.0000"/> </div>
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Performance conditions

Equity award vesting triggers

Vesting of equity awards can be triggered in several ways:

Time-based awards: With time-based awards, the holder can earn full rights according to a vesting schedule that typically includes a one-year cliff.

Performance-based: Typically given to executives, performance-based awards allow the holder to earn equity if certain performance conditions are met, either by the individual or the company.

Historically, performance-based equity was used sparingly in the United States. Since the early 2000s, the use of performance awards has steadily risen, with over 50% of U.S. companies offering some form of performance equity program, primarily focused on executive compensation.

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To better align the goals of the employee to those of the company and its shareholders, companies tie the vesting of equity awards to the successful recognition of an event.

THREE TYPES OF PERFORMANCE CONDITIONS

- 1. Non-market
- 2. Event-based
- 3. Market

For non-market performance conditions, the company will accrue expense once it is likely that the performance condition will be achieved (audit guidance points to a greater than 75% confidence that it will occur). If the expected and actual outcome of the performance-contingent vesting requirements varies from prior expectations, the expense accrual is adjusted to reflect the new expectations.

As a specific non-market award, an event-based performance condition doesn't impact the fair value of the award, but determines whether vesting is probable or not. The payout is either 0% or 100%. A company recognizes expense only when vesting occurs and does not recognize any expense if the event has not occurred. The most common example is an IPO or acquisition performance condition.

Market performance conditions are based on vesting conditions that have some dependency on the public market, outside of the company's control. The fair value of the award considers the probability of meeting the performance condition and expense is recognized regardless if the performance condition is met as long as the individual is still providing service when the condition was expected to be achieved.

HOW CARTA HELPS

Carta's expense reports currently support NSOs and RSUs with time-based vesting in conjunction with event-based or non-market based performance conditions. Market performance conditions are not supported at this time.

Our reports will calculate the cumulative amount of expense to date depending on what the company inputs as the expected payout percentage and timing of the performance condition.

[Learn more about expensing equity awards with performance conditions](#)



Financial reporting

SCENARIO

Default

- Reports
- Fair value assumptions
- Methodology
- FRVs
- Performance awards**
- Forfeiture rates
- Volatility
- Cancellations

In-progress performance condition estimates

Condition name	Payout range	High confidence	Estimated recognition date	Expense multiplier
\$50M revenue	50%-150%	Yes	01/01/2025	95.00% Edit

Evaluated performance conditions

Condition name	Status	Payout percentage	Recognition date
\$50M revenue	Achieved	100.00%	01/01/2023

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Canceling an equity grant

There are many different reasons companies may want to cancel an equity grant. Depending on the nature of the cancelation, there may be a variety of different accounting behaviors.

In Carta, companies should select a cancellation treatment within the Financial Reporting settings to determine how cancelled awards are treated in the expense reports.

Note that a cancellation is different from a forfeiture as a result of a termination of service.

A forfeiture refers to invested shares that an employee forfeits because they are leaving the company. A cancellation voids the entire award, including both the vested and unvested shares.

When an award is canceled but accompanied with a replacement award, the award is considered modified, which may result in incremental compensation expense that is recognized throughout the remaining service period.

[Read more about cancellations](#) →

HOW CARTA HELPS

Carta's valuation team may be able to assist with calculating the incremental expense depending on the nature of the modification.

Given the vast variety of cancellation situations, Carta asks the company to select a cancellation treatment to dictate how the report should treat the expense:

Review cancellations

Running a report without creating cancellation treatments will result in errors, and you will not be able to chain off of that report.

Award	Award type	Stakeholder name	Cancellation date	Cancellation treatment	Amendment type
ES-4	ISO	Judith Nichols	03/24/2014	Cash settlement	
ES-211	ISO	Anne Caron	10/02/2020	Amendment	Type I
ES-208	RSU	Tagg Palmer	02/01/2020	For no consideration	
ES-209	RSU	Tagg Palmer	02/01/2020	Clerical error	
ES-210	RSU	Tagg Palmer	02/01/2020	Cash settlement	
ES-21	RSU	Lisa Wonderly	02/17/2022	For no consideration	
ES-5	RSU	Diego Gutierrez	06/03/2016	Cash settlement	
ES-212	RSU	Lauren Burke	09/14/2021	Amendment	Type I
ES-115	RSU	Lois Starks	01/24/2019	Clerical error	

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Modifying award terms

Awards are valued on the grant date when all parties have agreed to the terms of the award. If the company later decides to modify the original terms or cancels an existing award while simultaneously replacing it with another award, the company may have to recognize incremental stock compensation expense if the modification makes the award more valuable.

[Read more about repricings](#) →

HOW CARTA HELPS

The expense reports account for modifications to a stock option's strike price (repricings). For other modifications such as an extension of the post-termination exercise period (PTEP) or an acceleration of vesting when service is terminated, Carta can manually calculate the incremental expense with a custom report.

Disclosure reports

At a high level, the purpose of the required minimum disclosures under ASC 718 is to help the users—such as company investors—of a company's financials better understand how the company structured its equity incentive Plan for stock compensation, the financial impact on the income statement, how the company calculates the fair value and amortized expense, and the cash flow effects to the company.

To achieve this, ASC 718 specifies the minimum information required with an extensive list of calculated values.

HOW CARTA HELPS

Carta's Disclosure Report calculates all of these values and provides them in an organized table. It is then up to the company to disclose the values on their financials in a manner that is most relevant to their situation. In addition, the award details that make up each of the calculated values are also provided in their respective worksheets within the Excel document allowing companies to audit the values.

Disclosure report

Expense summary

Expense recognized in period	\$681,275.56
Total fair value of options granted in period	\$1,481,748.41
Total fair value of options vested in period	\$155,181.04
Total fair value of restricted shares vested in period	\$134,068.75
Options—Unamortized expense	\$1,642,179.70
Options—WARRP* of unamortized expense	2.919
Restricted shares—Unamortized expense	\$5,345,556.08
Restricted shares—WARRP of unamortized expense	2.308

*Weighted Average Remaining Requisition Period

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Disclosure report

Options outstanding	Options	Weighted avg. exercise price	Aggregate intrinsic value	Weighted avg. grant date fair value	Weighted avg. remaining contractual term
Outstanding (Start)	288,000	\$10.09	\$996,800.00		8.975
Unvested outstanding	236,230	\$11.22	\$549,275.50	\$4.28	9.130
Vested outstanding	51,770	\$4.91	\$447,524.50		8.270
Granted	636,000	\$6.10		\$5.26	
Granted in period	636,000	\$6.10		\$2.33	
Granted out of period	0				
Changed (Performance conditions)	0				
Changed in period	0				
Changed out of period	0				
Exercised	0				
Exercised in period	0				
Exercised out of period	0				
Forfeited (Unvested)	170,000	\$13.55		\$5.26	
Forfeited in period	170,000	\$13.55		\$5.26	
Forfeited out of period	0				
Expired (Vested)	0				
Expired in period	0				
Expired out of period	0				
Outstanding (End)	754,000	\$5.94	\$117,700.00		8.866
Unvested outstanding	601,481	\$6.06		\$2.40	
Vested outstanding	152,519	\$5.50	\$91,263.00		7.814
Exerciseable	604,000	\$5.91	\$117,700.00		8.812
Expected to vest	601,481	\$6.06	\$26,437.00		9.133
Vested and expected to vest	754,000	\$5.94	\$117,700.00		8.866

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