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NEWSLETTER SLOVAKIA

SETTING FOUNDATIONS

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## → Law

### Legal regulation of crowdfunding

Wondering what to invest in during the current inflation? How to allocate your investment portfolio? One of the options is to get involved in crowdfunding as an investor or in group or collective investing through a crowdfunding platform. Although this is an innovative form of financing, it is not the "wild west" anymore. Also in Slovakia there are companies operating such platforms and enabling this form of investing and access to finance without the participation of banks. More importantly this area is already regulated by legislation at European level.

In particular, **the Regulation (EU) 2020/1503 of the European Parliament and of the Council of 7. October 2020 on European crowdfunding service providers for business and amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937 (the "Regulation")**, which applies from 10. November 2021. The Regulation is part of the "digital" regulatory revolution. It sets out clear requirements for the organisation, authorisation and supervision of providers of crowdfunding services, the operation of crowdfunding platforms, as well as transparency and marketing communications in relation to the provision of such services. **The transitional period for the provision of crowdfunding services under national law will expire shortly, on 10. November 2022, or possibly by an earlier authorisation to operate.**

The regulatory framework governing crowdfunding in the European Union is also complemented by a set of regulatory technical rules and implementing technical rules (Level 2 legislation), which are expected to be adopted and published in the Official Journal of the EU in the near future. The draft Level 2 legislation is currently published on ESMA's website in the form of a final report.

#### Crowdfunding – the definition

The Regulation also clarifies and unifies many terms in the field of crowdfunding. It defines crowdfunding itself as a "**crowdfunding service**", which is 'the matching of business funding interests of investors and project owners through the use of a crowdfunding platform.' Depending on whether the supporter receives consideration for the funds provided, the nature of that consideration and the legal nature of the relationship between the persons concerned, we

distinguish in particular between the following forms of crowdfunding:

- **donation-based model** - when supporters usually contribute to a project of a smaller scale, for example, to support the development of art, science, charitable or public benefit purposes and do not expect any consideration from the person requesting a contribution to their project,
- **rewards-based models**, where supporters are entitled to receive a consideration from the person requesting a contribution to their project:
  - **rewards-based crowdfunding**, where supporters typically receive a material (not financial) reward for providing funds, such as a product or service, from the project owner,
  - **lending**, loan-based crowdfunding or crowdlending, where supporters or investors lend funds to specific individuals, usually for their business activities, on a group basis and with interest. This includes peer-to-peer lending (also referred to as P2P or person-to-person lending),
  - **investment-based crowdfunding** or crowdfunding, where supporters become equity investors in companies (taking a stake in their assets) or co-owners and
  - **hybrid** or combined models.

The types of crowdfunding regulated by the Regulation are other rewards-based models, namely **crowdlending** (facilitating the provision of loans) and **crowdfunding** (facilitating financing through transferable securities or admitted instruments for crowdfunding purposes). Excluded from the scope of this Regulation are so-called P2P (peer-to-peer) crowdfunding platforms, which are aimed at intermediating consumer loans between consumers.

Thus, the main actors involved in crowdfunding are **the service provider** (of the crowdfunding), **the investor** (sophisticated and non-sophisticated) and **the project owner**.

**A crowdfunding service provider** or a crowdfunding platform operator is a regulated and licensed entity under the Regulation, which can only be a legal entity that connects the demand for funding for a particular project with persons willing to provide funds for this purpose. In the Slovak Republic, the National Bank of Slovakia is the

competent regulatory authority granting permission for the provision of crowdfunding services.

**An investor** is defined in the Regulation as “any natural or legal person who, through a crowdfunding platform, grants loans or acquires transferable securities or admitted instruments for crowdfunding purposes.” Importantly, the Regulation divides investors into “sophisticated” and “non-sophisticated” investors, with a sophisticated investor being a professional client under MiFID II and persons who have been approved by the service provider as sophisticated investors. A non-sophisticated investor is an investor who is not a sophisticated investor and has the benefit of a 4 day pre-contractual **reflection period**, i.e. cancellation of an offer to invest without penalty. He must also pass an initial knowledge test and a simulation of the ability to bear loss.



**A project owner** is defined in the Regulation as “any natural or legal person who seeks funding through a crowdfunding platform” where a crowdfunding project is “the business activity or activities for which a project owner seeks funding through the crowdfunding offer”, with a total consideration of less than 5 million EUR. Crowdfunding is not only a good way of obtaining a loan for a business, but also provides other benefits to project owners. Getting financial backing for a project also means supporting the project idea and the business plan. It can also be an effective form of marketing.

## Investor protection

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The main reason for the adoption of the Regulation, apart from the desire to facilitate alternative access to finance on equal and regulated terms for project owners (in particular SMEs, start-ups and scale-ups), was also investor protection. The investor is protected at several levels. The service provider is bound by the Regulation to ensure at least a **minimum level of**

**due diligence** in relation to the project owners. Further, the service provider must have **adequate systems and controls in place for the management risks** and must provide such services in accordance with the requirements of the Regulation or face fines of up to 500 000 EUR or 5 % of annual turnover. The Regulation also imposes extensive information obligations on the service provider - it must provide potential investors with a **key investment information sheet and regularly inform the investor by electronic means about its portfolio**. The service provider is also subject to **prudential requirements**, either in the form of own funds or an insurance policy, or a combination thereof, of 25 000 EUR and ¼ of the fixed overheads for the previous year. The service provider must also allow clients to advertise their interest in the sale of loans or transferable securities on an electronic bulletin board and keep records relating to the services and transactions for a period of 5 years.

## Benefits and risks of investment based crowdfunding

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Investment based crowdfunding is a method of long-term investment in one or more companies (portfolio) from different business areas, which the investor chooses from the service provider's offer according to what appeals to him/her, which area he/she is close to and understands, or according to other criteria. The investor thus becomes a partner in, for example, a property development or cosmetics company through a special purpose vehicle - a SPV. This connects supporters with businesses.

Of course, such investing also carries risks. If the project owner does not achieve the planned growth, the investor may lose all the funds invested. It is therefore not recommended to invest more than 10 % of the investor's net assets. The service provider is also obliged to point out to investors that such investments are not covered by a deposit guarantee scheme established in accordance with Directive 2014/49/EU, nor by an investor compensation scheme established in accordance with Directive 97/9/EC.

However, crowdfunding also has advantages over other forms of investing. The advantage of this form of investing is that the investor has control over the investment and is able to co-determine it. The investor may have the right to exercise voting rights in the company according to the amount of the investment (there is always a minimum investment) and thus participate in decision-making in matters of corporate governance. Another advantage of such investment is that the investor has the same right

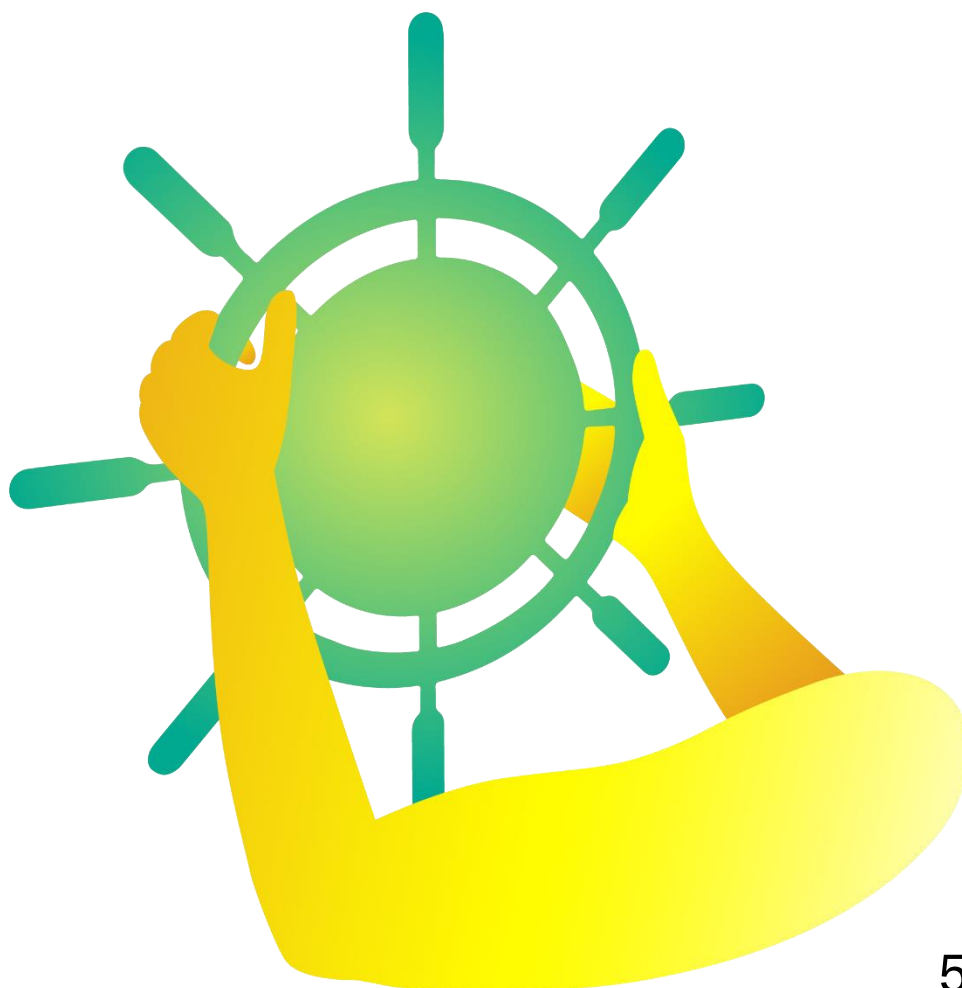
to receive a share of the company's profits as the founders/shareholders of the company themselves (these can range from 30 % to 50 %), with a liquidity preference. That means, the investor is paid out preferentially on exit.

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## → Business

### Change of the board allowance amount as of 1. September 2022

As of 1. September 2022, the board allowance amount is being increased again and that means also a change of the employee boarding contribution limits. The last change of the board allowance amount took place in May 2022. The reason for the repeated change is the mechanism used to determine the board allowance amount on basis of the price index development. In a nutshell, the higher the inflation, the higher the board allowance amount. The change will apply to all alternatives of boarding provision, the meal voucher as well as the financial contribution.

The board allowance amount according to time periods is as follows:

- 6,40 EUR for the time period of 5 to 12 hours,
- 9,60 EUR for the time period of more than 12 hours to 18 hours,
- 14,50 EUR for the time period of more than 18 hours.

#### Employee boarding expense as of September 1, 2022

Employee boarding contributions granted in terms of the conditions stipulated in the Labour Code represent tax-deductible expense. Based on the Labour Code, the employer is obliged to grant boarding contributions to employees as follows:

- in the amount of at least 55 % from the meal price,
- for each meal up to the amount of 55 % from the board allowance granted in case of a business trip lasting from 5 to 12 hours, i.e. as of 1. September 2022, up to the maximum amount of 3,52 EUR,
- the minimum amount of a meal voucher representing at least 75 % from the board allowance granted in case of a business trip lasting from 5 to 12 hours represents as of 1. September 2022, 4,80 EUR.

#### Employer contribution to employee boarding in tax-deductible expense of the employer as of 1. September 2022

	Minimum	Maximum
Own catering facility of facility of another subject	55 % from the meal price	55 % from the amount of 6,40 EUR, i.e. <b>3,52 EUR</b>
Meal voucher or financial contribution	55 % from the meal voucher minimum amount, i.e. <b>2,64 EUR</b>	55 % from the amount of 6,40 EUR, i.e. <b>3,52 EUR</b>

In terms of the stated overview, the employer is obliged to grant boarding contributions in the maximum amount of 3,52 EUR per day. Except for the stated amount, the employer can grant employee boarding contributions from the social fund as well. The amount of the contribution from the social fund is not limited.

The boarding contribution of the employer exceeding 3,52 EUR, which was not granted from the social fund, represents taxable income of the employee.

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## Accounting estimates

Accounting estimates affect many significant items in the financial statements and their inappropriate adjustments can reduce the reliability and credibility of the financial statements. Therefore, as an accounting entity it is necessary to give to estimates due professional consideration.

Given the current complex situation (post Covid-19 period, ongoing conflict in Ukraine, increase in the energy price as well as other inputs, high inflation rate, etc.), an entity should take a more rigorous approach to identifying, analysing and evaluating the risks associated with the valuation of the various components of assets in the financial statements than at other times. Some situations may not immediately appear to require a valuation adjustment.

However, we provide a few examples where, in our view, an entity should consider whether a valuation adjustment is necessary:

- **Production equipment** that, due to the aforementioned facts, will not produce (production will be suspended), production capacity will be significantly reduced, whether due to cost inefficiency, loss of sales of products
  - it is necessary to consider adjusting the valuation in the financial statements not only in the form of depreciation, but also by an allowance,
- **Fixed assets** - production equipment whose depreciation schedule is estimated by the entity to be 6 years, but the equipment is still capable of producing for another 4 years after this period. This is an indication that the depreciations were incorrectly estimated when the asset was placed in service and also that the depreciation plan was not regularly reviewed,
- **Inventories** whose net realisable value is lower than the accounting valuation due to significant increases in input prices or transport costs (which cannot be reflected in the selling price) - the difference by which the accounting valuation exceeds the net realisable value must be covered by an allowance at the date of financial accounts,
- **Inventories** for which it is almost certain that they will not increase the economic benefits of the entity in the future because of the loss of a market outlet (Ukraine, Russia, or a customer trading with those countries) - if the entity has inventories in stock for which the sale / marketability is doubtful or unlikely, their valuation should be adjusted by making an allowance or permanently derecognising them from the accounts,

- **Receivables for deliveries** that the entity has already made but there is information that the customer will not pay its obligation, either because of insolvency due to rising input prices or as it is a customer from a risky country - the valuation of such uncollectible receivables should be adjusted by making an allowance or derecognised if the company permanently refrains from collecting the receivable,
- **Provisions for events** that have occurred up to the date of the financial statements and that are likely to reduce the economic benefits of the entity in the future - for example, if an entity has decided to reduce the number of employees, a provision for severance pay is required in the financial statements as well as other entitlements of the employee on termination of employment. For example, if an entity has a long-term contract with a customer but, due to changes in market conditions (rising input prices, inflation, conflict in Ukraine), it is almost certain that it will not be able to pass on the increased costs to the customer in the form of a similar increase in the selling price, a provision for a loss contract should be made in the financial statements.



### Legislative framework and our experience

One of the most important accounting policy tools is valuation. Valuation is regulated by Act No 431/2002 Coll. on Accounting (hereinafter also referred to as the Accounting Act) in the fifth part of the Accounting Act, entitled 'Valuation methods', and by Measure No 230454/2002-92 of the Ministry of Finance of the Slovak Republic, which lays down details of accounting procedures and the framework chart of accounts for entrepreneurs for in the double-entry book-keeping system (hereinafter also referred to as the 'accounting procedures'). The valuation of assets,

liabilities, income, and expenses uses different methods, different valuation variables and, in several cases, estimates.

**Accounting estimates** are monetary amounts in the financial statements that are subject to measurement uncertainty. Accounting estimates take into account the risks, losses and impairment of assets and liabilities at the date of the financial statements. It can also be said that accounting estimates involve subjective assumptions, measurement uncertainty and complex processes that make it difficult to determine the reasonableness and accuracy of accounting estimates and create room for management bias and error. Accounting estimates include depreciation, provisions, and allowances.

**The valuation of assets** is adjusted by depreciation and creation of allowances. Pursuant to Section 28(4) of the Accounting Act, an entity depreciates tangible assets, other than inventories, and intangible assets (other than receivables) over their expected useful lives corresponding to the consumption of the future economic benefits of the assets. Intangible and tangible fixed assets are depreciated indirectly on the basis of a depreciation schedule by means of accounting depreciation (Section 20(1) of the accounting procedures). Depreciation reflects the permanent diminution in value of intangible and tangible fixed assets and the determination of the depreciation period is one of the key accounting estimates. In developing a depreciation plan, an entity takes into account, in particular:

- the expected use of the asset and the intensity of its use,
- the expected physical wear and tear, which depends on the normal conditions of use (shift patterns, repair, and maintenance schedule, etc.),
- technical and moral obsolescence.

A frequently used simplification is to set accounting depreciation at the level of tax depreciation. However, this is not the correct procedure, as tax depreciations are mandatorily determined by Act No. 595/2003 Coll. On the other hand, the accounting depreciations are supposed to take into account the expected useful life of the assets specific to the company in question. A further simplification is the determination of the depreciation period according to the group's methodology. Although the consolidation of the depreciation period for the purposes of the parent company's consolidated financial statements is understandable, we consider it to be incorrect to use these rates for the purposes of the local (statutory) financial statements without assessing their appropriateness. While we understand the practical motives of Slovak companies and their

efforts to eliminate temporary (and permanent) differences between local statements and group "reporting", the financial expression of the difference between the two variables can often have a significant impact on the financial statements. According to changing conditions, the depreciation schedule should be reviewed, and the residual depreciation period or depreciation rates adjusted (paragraph 20(5) of the accounting procedures). An entity should assess and, if necessary, reassess the depreciation schedule and depreciation rates at least once a year, namely at the date at which the financial statements are prepared.



**Allowances** are made to the valuation of assets in accordance with Section 26(4) of the Accounting Act when there is a reasonable expectation that the asset value will be temporarily impaired in comparison with its accounting valuation. Allowances shall be reversed, or their amount changed if there is a change in the presumption of impairment.

In practice, for example, Allowances for receivables are most often made as follows:

- **due date** - the entity specifies in an internal regulation how many days after the due date of the receivable it sees a risk of non-payment. Here again, the professional judgement of the management is important, as the risk interval may be different in different industries (for example, in agriculture or healthcare, longer payment periods are common, but this may not yet indicate a risk of non-payment). It should also be noted that the provision of Act No 595/2003 on income tax (Article 20(14)) defining the possibility to include the creation of an allowance in tax expenses is not correctly applied for accounting purposes. We consider the use of historical experience to be the correct approach, that means assignment of the percentage of outstanding claims for each age group (e.g. a company finds by analysis that of the receivables that are more than 180 days past due and less than 360 days past due, 12 % have



never been paid or recovered in court in the last 5 years – therefore the correct allowance percentage for this age group in this example should be 12 % – assuming that there has been no significant change in other material assumptions such as court collection practices, significant change in customer structure, overall insolvency in the industry, etc.),

- **risk of non-payment** – if the company's management identifies a reasonable expectation of impairment (e.g. the customer is in litigation for payment of the receivable, the customer does not respond to payment requests / does not communicate, the customer has been declared bankrupt, etc.),
- **so called lump-sum allowance** – sometimes the entity also creates a lump-sum allowance for simplicity, often the methodology is taken from group accounting rules. We often see it at the level of 2% to 5% of the value of receivables not covered by an individual allowance (although the risk of non-payment may not exist). However, this approach is not correct from the point of view of the Slovak accounting rules, where receivables should be assessed individually, or grouped according to risk into homogeneous groups, and the risk of impairment should be taken into account. Alternatively, the amount of such a lump-sum allowance can be based on an analysis similar to that described in the first bullet point, whereby the risk of non-payment is assessed at the level of the entire portfolio of receivables.

Section 26(1) of the Accounting Act states that if the future economic benefits of inventories are less than their accounting valuation at the date the financial statements are prepared, they are measured at net realisable value. Net realisable value is the estimated selling price of inventories less the estimated costs of completion and costs of disposal. The negative difference between the net realisable value of inventories and their carrying amount (i.e. the expected loss on sale) is taken into account by making an appropriate allowance.

**Provisions** are liabilities whose timing or amount is uncertain (Section 26(5) of the Accounting Act). Provisions are valued at an amount estimated to be sufficient to settle the present obligation at the date of the financial statements, taking into account risks and uncertainties (paragraph 19(1) of the accounting procedures). In other words, a provision is a liability representing an existing obligation of an entity that arises from past events and is likely to reduce the entity's future economic benefits, and if the exact amount of the liability is not known, it is valued at an amount estimated to be sufficient

to settle the present obligation. In particular, it is essential that it is an existing obligation. This means that, at least at the reporting date, an event has already occurred that requires a provision to be made.

Provisions with a significant degree of estimation include, for example:

- **retirement allowance provision** - based on the employee's entitlement (in accordance with current legislation) to a minimum of one month's average earnings on retirement. An employee may be granted a higher entitlement by an internal regulation of the entity or by collective agreement. This provision should be made as soon as the employee's employment commences, not, as is sometimes the case in practice, for example, only for a selected set of employees (say, over 50 years of age) or only in the last year preceding the year in which the employee retires. The value of the provision should be the amount of average monthly earnings adjusted for a number of internal and external assumptions:

- **discounting** - since this is a long-term provision, the calculation should be converted to the present value of future cash outlays. The most commonly used discount rate is the interest rate on government bonds (called the risk-free interest rate) with a similar maturity to the expected severance payments. The higher the interest rate, the lower the provision. This is an external assumption, with a high degree of confidence,
- **turnover** – takes into account the likelihood of an employee leaving the company, which will terminate the company's obligation to pay severance. This is an internal assumption, which may have a high degree of reliability, especially in larger, more stable companies. In order to be relevant for the calculation, the indicator needs to take into account at least the last 5 years (while it does not have to be an average value, it is necessary to monitor and assume trends). However, if there are unusual values in the period under review (due to extraordinary situations such as the year of the COVID pandemic or the restructuring of positions in the company), it is necessary for the management to assess them individually and reconsider their impact on the overall calculation,
- **other factors** – other assumptions should be included in the calculation to help refine it, such as wage growth in the

economy or regular wage indexation in the company, statistical probability of life expectancy, etc.

- **provision for warranty repairs** – if an entity provides after-sales service in the form of warranty repairs to products/goods sold by it, a provision shall be made for such future expenditure. The most common calculation is to set the amount as a percentage of the volume of products/goods sold. Here, the historical experience with claims and warranty repairs is a very important indicator increasing the reliability of management's assumption. This means that the entity should keep a record of claims and warranty repairs and can then assess that, given the financial terms and frequency of warranty repairs, their value is, for example, 2% of the value of sales of products/goods.

In the text, we have given just a few examples of what may happen in the current turbulent and uncertain future. Therefore, it is critical that an entity supports its subjective estimates with objective facts that help to demonstrate that the estimate is sufficiently accurate (i.e. that it does not result in a material misstatement of the financial statements). These may include, for example, historical experience and trends (determining the depreciation period, determining the amount of the percentage of the allowance or provision for warranty repairs), publicly available and observable market data (rising input prices, deteriorating solvency of customers), and others. To minimise the risk of an

inaccurate estimate, it is recommended to have as much objective information as possible from the external and internal environment regarding a particular estimate. Because a greater number of variables often enter into the determination of an estimate, we recommend that management focus on those inputs that have the greatest impact on the determination and could, individually or in aggregation with other inputs, result in a significant imprecision. Management should therefore have stipulated a materiality threshold in relation to the company's financial statements. It is also advisable to prepare a sensitivity analysis in which the company identifies which assumptions, and at what extreme values, will lead to significant effects on the financial statements. In this way, management can effectively focus attention on what is material and delegate less important areas to lower levels of management.

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