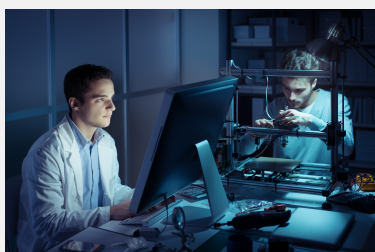




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## Audit preview

Information on an upcoming audit



# EU Support for SME Innovation: The SME Instrument

April 2019

Traditionally, start-ups and small and medium-sized enterprises (SMEs) in the EU have faced difficulties in commercially exploiting their innovations. Many innovations with commercial potential have failed to make the transition from the laboratory to the marketplace. This may partly be due to a gap in funding: both fundamental and applied research are usually supported through public (including EU) money, whereas the market phase tends to be funded privately. However, it is in the transition between these two phases that most innovation projects have faltered. The aim of the “SME instrument” is to develop and capitalise on the innovation potential of SMEs by filling the gap in funding for early-stage, high-risk research and innovation, boosting innovation and increasing private-sector commercialisation of research results.

The European Court of Auditors is conducting an audit on whether the SME instrument actually supports innovation by SMEs as intended. In particular, we will examine its design, monitoring and follow-up, and whether the Commission has taken action to address the challenges facing SMEs with a high potential for innovation. The audit will also examine complementarities between the SME instrument and other EU and national programmes, as well as other support the instrument provides in the form of coaching, networking and other assistance to help leverage further investment.

If you wish to contact the audit team, you may do so at the following email address:

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## **The SME instrument: bridging the innovation gap from lab to market?**

### **Innovation as a strategic priority**

The 2000 Lisbon Strategy set the EU the objective of becoming a knowledge-based economy centred on an ambitious research and innovation agenda. The Europe 2020 Strategy, adopted by the European Council in 2010, reiterated the importance of innovation activities to boost growth and employment in the EU. The “Innovation Union” is one of the seven flagship initiatives of the Europe 2020 Strategy. Its aim is “to create an innovation-friendly environment that makes it easier for great ideas to be turned into products and services that will bring economy growth and jobs”.

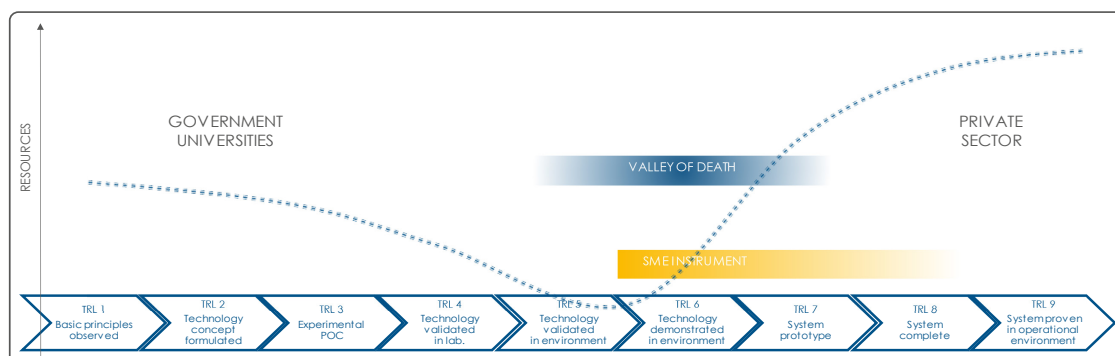
### **The “European paradox”**

Traditionally, start-ups and small and medium-sized enterprises (SMEs) in the EU have faced difficulties in commercially exploiting the innovations born of scientific research. Many innovations with commercial potential have failed to make the transition from the laboratory to the marketplace. This may be due partly to a gap in funding: both fundamental and applied research are usually supported through public (including EU) money, whereas the market phase tends to be funded privately. However, it is in the transition between these two phases that most innovation projects have faltered. This has given rise to the “European paradox”: the fact that, in many areas, Europe is at the forefront of research – in terms of publications – but lacks the entrepreneurial capacity to translate this into innovation, growth, and jobs.

Even where a research project does have commercial potential, it can often fail at the critical juncture between public and private funding (see [Figure 1](#)). The SME instrument represents the EU's latest attempt to bridge this gap, by helping bring research ideas to market in the form of innovative products or services. The programme supports start-ups and SMEs as the vehicles for this process.



**Figure 1 – “Valley of death” of an innovation project**



Source: ECA.

## EU support for SMEs and innovation: a brief history

Since 1984, the EU has funded research via Framework Programmes for Research and Technological Development (“Framework Programmes” or “FPs” for short).

“Horizon 2020”, currently in progress, is the eighth such programme. Traditionally, Framework Programmes have supported academic or scientific research, leaving it up to the private sector to fund commercial innovation. The finance gap for new and small firms involved in the early stages of innovation, especially in the market for high-risk capital, has traditionally represented a serious barrier to innovation.

The idea of supporting SMEs to bridge the gap between research and the marketplace emerged in the sixth Framework Programme, in the form of the “Research for the benefit of SMEs” programme. This provided non-financial support for SMEs through “knowledge providers” (mainly research organisations and universities). However, economic studies showed that this programme had limited economic impact for the participating SMEs and did not really help them in bringing innovative products and services to market<sup>1</sup>.

## Why focus on SMEs?

SMEs form the backbone of the EU economy. In 2016, SMEs employed 93 million people and, excluding the financial sector, accounted for 99 % of companies operating in the EU, 67 % of total employment and 57 % of value added. Academic studies<sup>2,3</sup> have demonstrated the relationships between entrepreneurship, SME activity, economic growth and job creation. SMEs also encompass start-ups. New firm creation and SME growth increase productivity and bring new or under-utilised resources into use<sup>4</sup>.

## Horizon 2020 and the SME instrument: a new approach

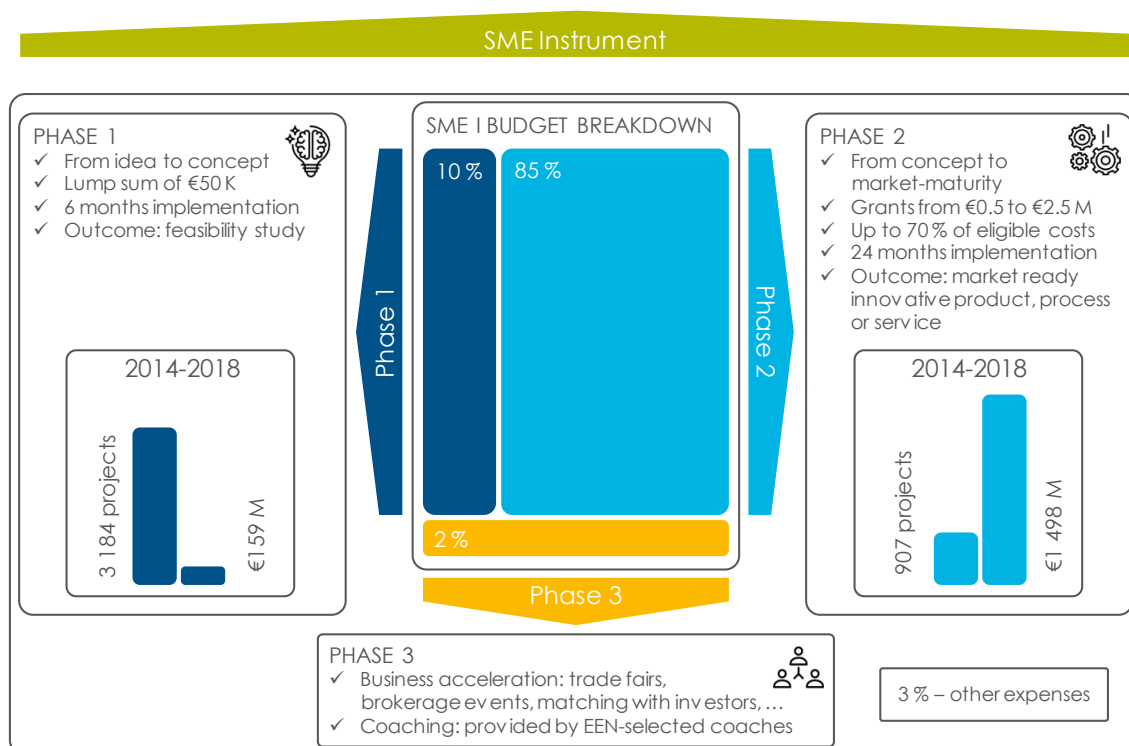
The EU has launched various instruments to help innovative SMEs access finance, notably financial instruments (loans, guarantees and venture capital) and grants (collaborative actions and the SME instrument). The SME instrument is entirely new, having been introduced under Horizon 2020. The SME instrument differs in a number of ways from other forms of support for SMEs. For a start, rather than supporting them with information, it actually funds individual private companies to run projects. It is also designed to cover the entire innovation cycle, from laboratory to market. By supporting start-ups and SMEs to commercially exploit innovations born of research, it seeks to plug the above-mentioned funding gap for research that is still at an early, high-risk stage.

### How does it work?

The SME instrument consists of three phases<sup>5</sup>, with the aim of covering the entire innovation cycle (see [Figure 2](#)):

- **investigation of technical and commercial feasibility of a business idea (Phase 1):** to explore the scientific or technical feasibility and commercial potential of new ideas. Business innovation lump sum grants for feasibility assessment purposes amounting to €50 000, with a 70 % co-financing rate;
- **development and demonstration (Phase 2):** to develop innovation with demonstration purposes. Examples of close-to-market innovation activities that can be supported include prototyping, miniaturisation, scaling-up, design, performance verification, testing, demonstration, development of pilot lines and validation for market replication, including other activities aimed at bringing innovation to investment readiness and maturity for market take-up. Grants can be up to €2.5 million (a higher amount can be granted if duly justified), with a 70 % co-financing rate;
- **additional EU support to enter the market (Phase 3):** focuses on support, training and coaching, as well as facilitating access to risk finance, by helping SMEs to set up meetings with potential private investors or by strengthening key soft skills. It consists of a bundle of services offered upon request to all SMEs benefiting from Phase 1 or Phase 2. SMEs do not receive any additional grant funding during this phase.

**Figure 2 – The SME instrument: structure and approximate budget distribution**



Source: ECA.

Despite the names given to the different phases, the model is not linear and the phases are not sequential. SMEs do not need to complete Phase 1 in order to participate in Phase 2. Phase 3 provides “soft support” to SMEs participating in either the first or the second phase. SMEs can take advantage of the Phase 3 “soft support” actions at any time during their innovation project, or even after completing it.

### What are the latest developments?

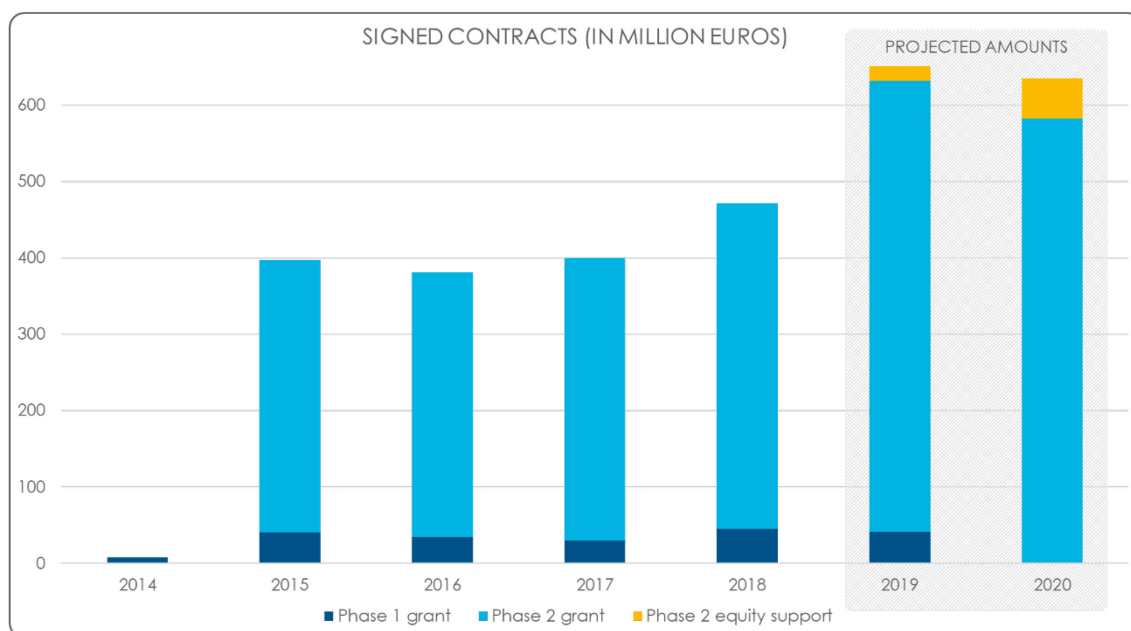
In 2018, the SME instrument was integrated into the “European Innovation Council (EIC) Pilot”, bringing together under the same work programme different instruments that were previously separate under Horizon 2020. The SME instrument is the main contributor to this pilot, providing around 70 % of the overall funding.

On 18 March 2019, the Commission launched the EIC Enhanced Pilot, with the aim of moving towards a fully-fledged EIC under the new Framework Programme. The main changes the pilot introduces to the SME Instrument are the possibility of applying for blended instrument as from June 2019 and the discontinuation of Phase 1 as from September 2019<sup>6</sup>.

## How much EU money is involved?

A budget of €3 billion has been earmarked for the SME instrument. This represents 33 % of the SME target for Horizon 2020 as a whole. The bulk of the funding has been allocated to Phase 2 projects. **Figure 3** shows the distribution of funds under the SME instrument each year in terms of signed grants.

**Figure 3 – EU funding per year and phase (in million euro)**



## Legal framework

The legal framework for the SME instrument derives mainly from the two Horizon 2020 Regulations:

- Regulation (EU) No 1290/2013 of the European Parliament and of the Council of 11 December 2013 laying down the rules for participation and dissemination in “Horizon 2020 – the Framework Programme for Research and Innovation (2014-2020)”;
- Regulation (EU) No 1291/2013 of the European Parliament and of the Council of 11 December 2013 establishing Horizon 2020 – the Framework Programme for Research and Innovation (2014-2020); Article 22 refers specifically to the SME instrument.

Council Decision 2013/743/EU of 3 December 2013 establishing the specific programme implementing Horizon 2020 is also applicable.

## Roles and responsibilities

### European Commission

Within the European Commission, the Directorate General for Research and Innovation (DG RTD) is responsible for policy development in relation to the SME instrument, while the Executive Agency for Small and Medium Enterprise (EASME) is in charge of implementing it.

### Focus of the audit

The European Court of Auditors is conducting an audit on whether the SME instrument under Horizon 2020 supports innovation by SMEs. In particular, we will examine whether:

- the SME instrument is properly designed to address the needs of SMEs with high innovation potential;
- the Commission has taken appropriate action to address the challenges facing SMEs with high innovation potential; and
- the Commission has adequately monitored and followed up the instrument in order to improve it.

In the course of our audit, we will analyse key issues identified during the preparatory phase. Since these issues are identified before the audit work commences, they should not be regarded as audit observations, conclusions or recommendations.

We will also draw on the results of a previous audit on support provided to innovative SMEs through loans and guarantees under the Seventh Framework Programme<sup>7</sup>.

### **ABOUT ECA SPECIAL REPORTS AND AUDIT PREVIEWS**

The ECA's special reports set out the results of its audits of EU policies and programmes or management topics related to specific budgetary areas.

Audit previews provide information in relation to an ongoing audit task. They are based on preparatory work undertaken before the start of the audit and are intended as a source of information for those interested in the policy and/or programme being audited.

If you wish to contact the team in charge of this audit, please do so through the following e-mail address:

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- <sup>1</sup> European Commission, Impact assessment of the SME-specific measures of the Fifth and Sixth FWP for Research on their SME target groups outsourcing research.
  - <sup>2</sup> NESTA (National Endowment for Science, Technology and the Arts), The vital 6 per cent. How high-growth innovative businesses generate prosperity and jobs 2009.
  - <sup>3</sup> Henrekson, M. & Johansson, D., 2010. Gazelles as job creators: a survey and interpretation of the evidence. *Small Business Economics*, 35, 227-244, p. 240.
  - <sup>4</sup> SMEs, Entrepreneurship and Innovation (2010) – OECD.
  - <sup>5</sup> This follows model of the Small Business Innovation Research (SBIR) programme; this is a United States Government programme coordinated by the Small Business Administration, intended to help certain small businesses conduct research and development.
  - <sup>6</sup> Horizon 2020 Work Programme 2018-2020. Towards the next Framework Programme for Research and Innovation: Enhanced European Innovation Council (EIC).
  - <sup>7</sup> Special report 20/2017: EU-funded loan guarantee instruments: positive results but better targeting of beneficiaries and coordination with national schemes needed.

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