
UNIT 8: BUDGETARY CONTROL

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8.0 OBJECTIVES

After studying this unit, you should be able to

- Explain the essentials of Budgetary Control
- State the objectives of Budgetary Control
- Discuss the advantages and limitations of Budgetary Control
- Describe the importance of Programme Budgeting
- Explain about Performance Budgeting
- Describe the significance of Budgetary Control Ratios

8.1 INTRODUCTION

Budgetary control is the process by which budgets are prepared for the future period and are compared with the actual performance for finding out variances, if any. The comparison of budgeted figures with actual figures will help the management to find out variances and take corrective actions without any delay. Budgetary control is the process of determining various actual results with budgeted figures of the enterprise for the future period and standards set then comparing the budgeted figures with the actual performance for calculating variances, if any. First of all, budgets are prepared and then actual results are recorded. The comparison of budgeted

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and actual figures will enable the management to find out discrepancies and take remedial measures at a proper time. The budgetary control is a continuous process which helps in planning and co-ordination. It provides a method of control too. A budget is a means and budgetary control is the end-result.

Example:

First, a budget needs to be created. To put it simply, a company performance budget is really just a set of financial goals that management wants to achieve. These could be sales or spending goals.

Second, after the budget is created, management needs to compare, analyse, and interpret the actual performance results with the budgeted goals. Management typically uses a budget report for this comparison.

Third, after the comparison has been made, managers need to improve the underperforming operations and continue to strengthen the favourable ones. The budget report easily allows managers to focus on unfavourable operations because all areas that meet the budget are marked with an F for favourable variance while the poorly performing areas are marked with a U for unfavourable variance.

The fourth and final step usually occurs at the end of an accounting period. After management has a chance to look over the entire last period, they can start making plans for the next year. For example, they will most likely review the original budget that was created and why certain goals were set. Then they will compare the actual with the budgeted performance over the entire period. Lastly, management will focus on how they tried to correct the problem operations and develop a plan to fix them in the next period.

Definition:

“According to Brown and Howard, “Budgetary control is a system of controlling costs which includes the preparation of budgets, coordinating the departments and establishing responsibilities, comparing actual performance with the budgeted one and acting upon the results to achieve maximum profitability.” Weldon characterizes budgetary control as planning in advance of the various functions of a business enterprise so that the business as a whole is controlled.

J. Batty defines it as, “A system which uses budgets as a means of planning and controlling all aspects of producing and/or selling commodities and services. Welsch relates budgetary control with day-to-day control process.” According to him, “Budgetary control involves the use of budget and budgetary reports, throughout the period to co-ordinate, evaluate and control day-to-day operations in accordance with the goals specified by the budget.”

Budgetary control refers to how well managers utilize budgets to monitor and control costs and operations in a given accounting period. In other words, budgetary control is a process for managers to set financial and performance goals with budgets, compare the actual results, and adjust performance, as it is needed.

- (a) The objects are set by preparing budgets.

- (b) The business is divided into various responsibility centres for preparing various budgets.
- (c) The actual figures are recorded.
- (d) The budgeted and actual figures are compared for studying the performance of different cost centres.
- (e) If actual performance is less than the budgeted norms, a remedial action is taken immediately.

8.2 ESSENTIALS OF BUDGETARY CONTROL

There are certain steps which are necessary for the successful implementation of the budgetary control system. These are as follows:

1. Organization for Budgetary Control

The proper organization is essential for the successful preparation, maintenance and administration of budgets. A Budgetary Committee is formed, which comprises the departmental heads of various departments. All the functional heads are entrusted with the responsibility of ensuring proper implementation of their respective departmental budgets. The Chief Executive is the overall in-charge of the budgetary system. He/She constitutes a budget committee for preparing realistic budgets. A budget officer is the convener of the budget committee who co-ordinates the budgets of different departments. The managers of different departments are made responsible for their departmental budgets.

2. Budget Centres

A budget centre is that part of the organization for which the budget is prepared. A budget centre may be a department, section of a department or any other part of the department. The establishment of budget centres is essential for covering all parts of the organization. The budget centres are also necessary for cost control purposes. The appraisal performance of different parts of the organization becomes easy when different centres are established.

3. Budget Manual

A budget manual is a document which spells out the duties and also the responsibilities of various executives concerned with the budgets. It specifies the relations amongst various functionaries.

4. Budget Officer

The Chief Executive, who is at the top of the organization, appoints some person as Budget Officer. The budget officer is empowered to scrutinize the budgets prepared by different functional heads and to make changes in them, if the situations so demands. The actual performance of different departments is communicated to the Budget Officer. He/She determines the deviations in the budgets and the actual performance and takes necessary steps to rectify the deficiencies, if any.

He/She works as a coordinator among different departments and monitors the relevant information. He/She also informs the top management about the performance of different departments. The budget officer will be able

to carry out his work fully well only if he is conversant with the working of all the departments.

5. Budget Committee

In small-scale concerns, the accountant is made responsible for the preparation and implementation of the budgets. In large-scale concerns, a committee known as Budget Committee is formed. The heads of all the important departments are made members of this committee. The Committee is responsible for the preparation and execution of budgets. The members of this committee put up the case of their respective departments and help the committee to take collective decisions if necessary. The Budget Officer acts as the convener of this committee.

6. Budget Period

A budget period is the length of time for which a budget is prepared and employed. The budget period depends upon a number of factors. It may be different for different industries or even it may be different in the same industry or business.

The budget period depends upon the following considerations:

- (a) The type of budget i.e. sales budget, production budget, raw materials purchase budget, capital expenditure budget. A capital expenditure budget may be for a longer period i.e. 3 to 5 years purchase, sale budgets may be for one year.
- (b) The nature of demand for the products.
- (c) The timings for the availability of the finances.
- (d) The economic situation of the country.
- (e) The length of trade cycles.

All the above-mentioned factors are taken into account while fixing period of budgets

7. Determination of Key Factor

The budgets are prepared for all functional areas. These budgets are interdependent and inter-related. A proper co-ordination among different budgets is necessary for making the budgetary control a success. The constraints on some budgets may have an effect on other budgets too. A factor which influences all other budgets is known as Key Factor or Principal Factor. There may be a limitation on the quantity of goods a concern may sell. In that case, sales will be a key factor and all other budgets will be prepared by keeping in view the amount of goods the concern will be able to sell. The raw material supply may be limited, so production, sales and cash budgets will be decided according to the raw materials budget. Similarly, plant capacity may be a key factor if the supply of other factors is easily available.

The key factor may not necessarily remain the same. The raw materials supply may be limited at one time but it may be easily available at another time. The sales may be increased by adding more sales staff, etc. Similarly, other factors may also improve at different times. The key factor also highlights the limitations of the enterprise. It will enable the management

to improve the working of those departments where scope for improvement exists.

8.3 OBJECTIVES OF BUDGETARY CONTROL

The main objectives of the budgetary control as follows:

1. Defining the objectives of the enterprise.
2. Providing plans for achieving the objectives so defined.
3. Coordinating the activities of various departments.
4. Operating various departments and cost centres economically and efficiently.
5. Increasing the profitability by eliminating waste.
6. Centralizing the control system.
7. Correcting variances from sit standards.
8. Fixing the responsibility of various individuals in the enterprise.

Check Your Progress A

State whether the following statements are **True** or **False**:

- a) The budgets are not prepared for all functional areas of management.
- b) A budget period is the length of time for which a budget is prepared and employed.
- c) A budget manual is a document which does not spell out the duties and also the responsibilities of various executives concerned with the budgets
- d) Fixing the responsibility of individuals in the enterprise is not the objective of budgetary control.
- e) The Budget Committee is not responsible for the preparation and execution of budgets.

8.4 ADVANTAGES OF BUDGETARY CONTROL

Budgetary control has become an important tool of an organization to control costs and to maximize profits. Some of the advantages of budgetary control are:

1. It defines the goals, plans and policies of the enterprise. If there is no definite aim, then the efforts will be wasted in achieving some other aims.
2. Budgetary control fixes targets. Each and every department is forced to work efficiently to reach the target. Thus, it is an effective method of controlling the activities of various departments of a business unit.
3. It secures better co-ordination among various departments.
4. In case the performance is below expectation, budgetary control helps the management in finding the responsibility.
5. It helps in reducing the cost of production by eliminating the wasteful expenditure.

6. By promoting cost consciousness among the employees, budgetary control brings in efficiency and economy.
7. Budgetary control facilitates centralized control with decentralized activity.
8. As everything is planned and provided in advance, it helps in smooth running of the business enterprise.
9. It tells the management as to where action is required for solving problems without delay.

8.5 LIMITATIONS OF BUDGETARY CONTROL

The following are the main limitations of the budgetary control suffers from many limitations, few of them are as follow:

1. It is really difficult to prepare the budgets accurately under inflationary conditions.
2. Budget involves a heavy expenditure which small business concerns cannot afford.
3. Budgets are prepared for the future period which is always uncertain. In future, conditions may change which will upset the budgets. Thus, future uncertainties minimise the utility of budgetary control system.
4. Budgetary control is only a management tool. It cannot replace management in decision-making.
5. The success of budgetary control depends upon the support of the top management. If there is lack of support from top management, then this will fail.

8.6 PROGRAMME BUDGETING

Programme budgeting, is the budgeting system that, contrary to conventional budgeting, describes and gives the detailed costs of every activity or program that is to be carried out with a given budget.

Programme budgeting was first evolved in the United States. In Britain, it is referred to as 'Output Budgeting'. It is mainly useful to government departments and non-profit organizations. In programme budgeting, special emphasis is laid on the formulation of different budgets for different programmes. It utilizes a planning and budgeting process in an output oriented programme format, which is oriented to its objectives to facilitate developing and evaluating alternatives.

It leads to the allocation of resources over a planning period. Programme budgeting integrates organization's all planning activities and budgeting into a total system.

What is a Programme Budget?

A program budget is a budget prepared specifically for a project or program. This type of budget includes expenses and revenues related to one specific project. No revenues or expenses of any other projects are mixed with this particular project.

A business has many different projects running at a single time. Therefore, it becomes very important to set the goals and objectives of each individual project, along with its budget. The program budget allocates resources to a project, which helps in monitoring the performance of the project and increases accountability.

Let us look at a Program Budget as an example to understand the concept more clearly.

Reyon Ltd. is in the textile business. It receives multiple orders from different clients every year. One of these clients, Noble Ltd., gave Reyon Ltd. an annual contract. Reyon Ltd. follows and prepares a program budget. Here, Reyon Ltd. shall prepare the program budget of Noble Ltd. by including all the income and expenses related to this single project. No other project shall be considered while preparing the budget for Noble Ltd. Thus, the program budget focus is only on the individual projects.

8.6.1 Process of Programme Budgeting

Under programme budgeting, programmes are identified for achieving different goals of the organization. Then each programme is divided into different elements. Resources such as materials, men, machines, utilities, etc. are allocated to various programmes over the period. The emphasis is continuously placed on analysis of alternatives (including existing programmes) and estimating the cost of accomplishing objectives and fulfilling purposes and needs.

The steps involved in the programming budgeting are as follows:

- (a) Identification of programmes required fulfilling the mission
- (b) Identification of programme elements
- (c) Allocation of resources to programmes
- (d) Utilizing forecast studies analysis-mostly multiyear forecasts are considered in programmed budgeting
- (e) Measuring the actual performance of approved programmes and comparing with budget performance

In the case of non-profit organizations, output indicators are to be developed because output can not be measured in monetary terms. For example, for training programmes, the output indicator may be in terms of number of employees trained. For health programmes, output indicator may be reduction in disease. The programme budget, however, does not eliminate the need for traditional budget. It adds only a new dimension to planning and budgeting system. A traditional budget can be divided into a number of programme budgets.

8.6.2 Advantages of Programme Budgeting

There are many advantages of a Program Budget which are as follows:

- It helps in determining the priority of the projects.
- It helps in planning and managing the delivery of services in the future.

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- It monitors the allocation of resources to a project and determines how they are used to meet the goals of the organization.
- It helps in identifying areas where cost reduction can be implemented and savings can be made.
- It helps in spotting the areas where higher levels of funds are required.
- It adds accountability to the organization. Since each project has its respective budget, performance measurement can be done and firm accountability can be set.

Apart from the advantages, there are also some disadvantages to program budgets.

8.6.3 Disadvantages of Programme Budgeting

Programme budgeting suffers from many limitations, some of them are as follow:

- A program budget requires a lot of information and it can take a lot of time to determine the exact financial resources required. Additionally, during the year, when any changes must be made to the resources required, it becomes very difficult to achieve a balanced budget.
- Sometimes, overlapping causes several changes to the budget. For example, the municipality department may include the electricity repair expenses in the budget, which may or may not occur. This leads to the budgeting of dual expenses.
- If the program budget is incorrect, it can lead to an increase in costs.
- The program budget sometimes makes it difficult to evaluate the performance of the project. Multiple layers of administrators govern a project, so finding out the actual performance of any administrator can become a daunting task.

8.7 PERFORMANCE BUDGETING

Performance budget (PB) may be defined as a budget based on functions, activities and projects. Performance budgeting may be described as a budgeting system, where under input costs are related to the end results, i.e. performance.

According to the National Institute of Bank Management, Mumbai, the PB is the process of analyzing, identifying, simplifying, and crystallizing specific performance objectives of a job to be completed over a period in the framework of the organizational objectives, purpose and objectives of the job.

It involves evaluation of the performance of the organization in the context of both specific as well as overall objectives of the organization.

8.7.1 Purpose of Performance Budgeting

The performance budget is an instrument through which financial resources are allocated according to purposes and objectives. The costs of various programmes proposed for achieving these objectives are clearly indicated. It also presents data for measuring worth performance of the accomplishment of objectives set under each programme. The focus of attention is not only

on expenditure but also on achievement. Both are integral parts of financial planning and expenditure authorization.

8.7.2 Process of Performance Budgeting

PB is a technique or a method employed by any agency/department. The first stage is to decide what its goal or objective should be, the next stage is to decide on a set of programmes in order to achieve the goal and then to implement the programme. Final stage is to evaluate the actual performance of each segment and its contribution towards achievement of its goal.

Steps in Performance Budgeting

- (a) Formulation of objectives of the agency/department.
- (b) Identification of various programmes or projects, which will help the agency to achieve its objective.
- (c) Evaluation of the programmes in terms of benefits that they produce compared to the resources that they consume.
- (d) Selection of the programmes on the basis of cost benefit analysis in order to utilize the funds in the optimal manner
- (e) Development of performance criteria for various programmes (suitable work measurement units, norms, yardsticks, standards, and other performance indicators)
- (f) Preparation of long-term physical as well as financial plans
- (g) Preparation of the annual budget
- (h) Assessment of performance of each programme and by each responsibility unit and comparison of the same with the budget
- (i) Undertaking periodical review of the programmes with a view to assess the strengths and weaknesses and make modification, if necessary.

8.8 BUDGETARY CONTROL RATIOS

Under the system of budgetary control, the actual performances are compared with budgeted performances so as to determine the deviations or variances. The deviations or variances may be favourable or unfavourable and may be expressed in terms of absolute figures or in terms of ratios.

Following control ratios are used by the management to know whether the deviations of the actual performance from the budgeted performance are favourable or unfavourable. If the ratio is 100% or more, the performance is considered as favourable and if is less than 100%, the performance is considered unsatisfactory.

$$(i) \quad \text{Capacity Ratio} = \frac{\text{Actual Hours Worked}}{\text{Budgeted Hours}} \times 100$$

This ratio indicates the extent to which budgeted hours of activity is actually utilised. If the ratio is 85%, budgeted capacity is utilised up to 85% and 15% capacity remains unutilised.

$$(ii) \quad \text{Activity Ratio} = \frac{\text{Standard Hours for Actual Production}}{\text{Budgeted production in terms of standard Hours}} \times 100$$

This ratio measures the level of activity attained during the budget period.

(iii) **Efficiency Ratio** = $\frac{\text{Actual Production in terms of Standard Hours}}{\text{Actual Hours worked}} \times 100$

This ratio measures the efficiency of the operation of the firm.

Check Your Progress B

Fill in the blanks

- a. secures better co-ordination among various departments.
- b. Budget involves a heavy expenditure which..... cannot afford.
- c. integrates all the organization’s planning activities and budgeting into a total system.
- d. is an instrument through which financial resources are allocated according to purposes and objectives.
- e. ratio indicates the extent to which budgeted hours of activity are actually utilised.

Example 1

Product X takes 5 hours to make and Y requires 10 hours. In a month of 25 effective days of 8 hours a day, 1,000 units of X and 600 units of Y were produced. The company employs 50 workers in the production department. The budgeted hours are 1,02,000 for the year. Calculate the Control Ratios, i.e., Capacity Ratio, Activity Ratio and Efficiency Ratio.

Budgeted hours for the month= 1,02,000/12 i.e. 8500 hrs per month

Actual Hours worked= 50 workers 25days 8 hours per day i.e. 10,000 hours

Standard hours for actual output

- (i) Hours allowed for 1000 units of product X = 1000 units × 5 hours = 5000
 - (ii) Hours allowed for 600 units for product Y= 600 units × 10 hours = 6000
- Total = 11,000**

(a) **Capacity Ratio** = $\frac{\text{Actual Hours}}{\text{Budgeted Hours}} \times 100$

$$= \frac{10,000 \text{ hrs.}}{8,500 \text{ hrs}} \times 100$$

$$= 117.65\%$$

(b) **Activity Ratio** = $\frac{\text{Actual Production in terms of standard hours}}{\text{Budgeted standard hours}} \times 100$

$$= \frac{11,000}{8,500} 100$$

$$= 129.41\%$$

(c) **Efficiency Ratio** = $\frac{\text{Actual Production in terms of standard hours}}{\text{Actual Hours worked}} \times 100$

$$= \frac{11000}{10000} = 1.1$$

Illustration 2

Two articles X and Y are manufactured in a department. Their specifications show that 2 X's or 8 Y's can be produced in one hour. The budgeted production for June, 2019 is 200 X's and 400 Y's. The actual production at the end of the month was 250 X's and 480 Y's and the actual hours spent on this production were 160. Find out the capacity, activity and efficiency ratios for June 2019. Also find out the calendar ratio if the actual working days during the month be 27 corresponding to 25 days in the budget.

Solution

Standard Budgeted Hours for June 2019:

$$\begin{aligned} X & \text{ — } 200 \div 2 = 100 \text{ Hours} \\ Y & \text{ — } 400 \div 8 = 50 \text{ Hours} \\ & \quad \quad \quad = \underline{150 \text{ Hours}} \end{aligned}$$

Standard Hours for Actual Production:

$$\begin{aligned} X & \text{ — } 250 \div 2 = 150 \text{ Hours} \\ Y & \text{ — } 480 \div 8 = 60 \text{ Hours} \\ & \quad \quad \quad = \underline{185 \text{ Hours}} \end{aligned}$$

$$\text{Capacity Ratio} = \frac{\text{Actual Hours Worked}}{\text{Budgeted Hours}} \times 100 = \frac{160}{150} \times 100 = 106.67\%$$

$$\begin{aligned} \text{Activity Ratio} &= \frac{\text{Standard Hours for Actual Production}}{\text{Budgeted Standard Hours}} \times 100 \\ &= \frac{185}{150} \times 100 = 123.33\% \end{aligned}$$

$$\begin{aligned} \text{Efficiency Ratio} &= \frac{\text{Standard Hours for Actual Production}}{\text{Hours worked}} \times 100 \\ &= \frac{185}{160} \times 100 = 115.62\% \end{aligned}$$

$$\begin{aligned} \text{Calendar Ratio} &= \frac{\text{Number of Actual Working Days in a Period}}{\text{Number of Working Days in the Budget Period}} \times 100 \\ &= \frac{27}{25} \times 100 = 108\% \end{aligned}$$

8.9 LET US SUM UP

Budgetary control is the process by which budgets are prepared for the future period and are compared with the actual performance for finding out variances, if any. The comparison of budgeted figures with actual figures will help the management to find out variances and take corrective actions without any delay. There are certain steps which are necessary for the successful implementation of the budgetary control system. These include Organization for Budgetary Control, Budget centre, Budget manual, Budget officer, Budget Committee, Budget period and Determination of Key Factor. There are many objectives of budgetary control, some of which are: Defining the objectives of the enterprise, providing plans for

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achieving the objectives so defined, coordinating the activities of various departments, Operating various departments and cost centres economically and efficiently, Increasing the profitability by eliminating waste etc. It has certain advantages and limitations The advantages are: It secures better co-ordination among various departments, In case the performance is below expectation, budgetary control helps the management in finding up the responsibility, It helps in reducing the cost of production by eliminating the wasteful expenditure, By promoting cost consciousness among the employees, budgetary control brings in efficiency and economy, Budgetary control facilitates centralized control with decentralized activity, As everything is planned and provided in advance, it helps in smooth running of the business enterprise. However, limitations are: It is really difficult to prepare the budgets accurately under inflationary conditions, Budget involves a heavy expenditure which small business concerns cannot afford, Budgets are prepared for the future period which is always uncertain. In future, conditions may change which will upset the budgets. Thus, future uncertainties minimize the utility of budgetary control system.

Programme budgeting describes and gives the detailed costs of every activity or program that is to be carried out with a given budget. Steps involved in the programming budgeting are as follows:

(a) Identification of programmes required fulfilling the mission, (b) Identification of programme elements, (c) Allocation of resources to programmes, (d) Utilizing forecast studies analysis-mostly multi-year forecasts are considered in programmed budgeting, (e) Measuring the actual performance of approved programmes and comparing with budget performance. It has many advantages and disadvantages which are :

Advantages: It helps in determining the priority of the projects, It helps in planning and managing the delivery of services in the future, It monitors the allocation of resources to a project and determines how they are used to meet the goals of the organization, It helps in identifying areas where cost reduction can be implemented and savings can be made, It helps in spotting the areas where higher levels of funds are required.

Disadvantages: A program budget requires a lot of information and it can take a lot of time to determine the exact financial resources required. Sometimes, overlapping causes several changes in the budget. This leads to the budgeting of dual expenses. If the program budget is incorrect, it can lead to an increase in costs; the program budget sometimes makes it difficult to evaluate the performance of the project.

Performance budget may be defined as a budget based on functions, activities and projects. Performance budgeting may be described as a budgeting system, where under input costs are related to the end results. The steps involved in performance budgeting include: (a) Formulation of objectives of the agency/department, (b) Identification of various programmes or projects, which will help the agency to achieve its objective, (c) Evaluation of the programmes in terms of benefits that they produce compared to the resources that they consume, (d) Selection of the programmes on the basis of cost benefit analysis in order to utilize the funds in the optimal manner, (e) Development of performance criteria for the various programmes

(suitable work measurement units, norms, yardsticks, standards, and other performance indicators), (f) Preparation of long-term physical as well as financial plans, (g) Preparation of the annual budget. Under the system of budgetary control, the actual performances are compared with budgeted performances so as to determine the deviations or variances. The deviations or variances may be favourable or unfavourable and may be expressed in terms of absolute figures or in terms of ratios which are Activity Ratio, Capacity Ratio and Efficiency Ratio.

8.10 KEY WORDS

Budgetary control is the process by which budgets are prepared for the future period and are compared with the actual performance for finding out variances, if any.

Programme budgeting describes and gives the detailed costs of every activity or program **that is to be carried out with a given** budget.

Performance budget is one that reflects both the input of resources and the output of services for each unit of an organization.

Variances in budgeting, a variance **is the difference between a budgeted, planned, or standard cost and the actual amount incurred/sold. Variances can be computed for both costs and revenues.**

8.11 ANSWER TO CHECK YOUR PROGRESS

- A** a-False, b-True, c-False, d-False, e-False
- B** a-Budget, b- small business concern, c- Programme Budgeting, d-Performance Budget, e-Capacity

8.12 TERMINAL QUESTIONS

1. What do you mean by Budgetary Control? State the objectives of budgetary control.
2. Define Budgetary Control? What are the essentials of a budgetary control system?
3. Describe the advantages and limitations of Budgetary Control.
4. Define Programme Budgeting. Explain the steps involved in programme budgeting.
5. Explain the advantages and disadvantages of Programme Budget.
6. What is meant by Performance Budgeting? What are its purposes. Discuss the process of performance budgeting.
7. Write short notes on the following giving examples.
 - Activity Ratio
 - Capacity Ratio
 - Efficiency Ratio