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MGT510: Managerial Accounting

Module Assignment: *Managerial Accounting Report*

Table of Contents

Introduction....3

Profit Statements Using Absorption Costing and Variable Costing....3

Profit statement for Swipe50 Limited for the month of February....4

Profit statement for Swipe50 Limited for the month of March....4

Variable Costing....5

Profit statement for Swipe50 Limited for the month of February....5

Profit statement for Swipe50 Limited for the month of March....6

Reconciliation....6

February....6

March....6

Differences Between Absorption and Variable Accounting....6

Importance of Absorption Costing....7

Importance of Variable Costing....8

Limitations of Absorption Costing....9

Limitations of Variable Costing....11

Recommendations for Improving Swipe's Accounting System....11

Implement an ERP System....12

Develop a Cash Flow Forecasting System....12

Improve Cost Accounting Systems....12

Managerial Accounting Jobs....13

Cost Control and Financial Management....13

Compliance with Regulations....13

Strategic Planning and Decision Making....14

Inventory Management....14

Performance Measurement and Reporting....14

Conclusion....14

References....16

Introduction

Absorption costing and variable costing are two independent accounting methodologies used by businesses to allocate and account for production costs (Cotter, 2021). Absorption costing assigns both variable and fixed manufacturing costs to products, offering a comprehensive approach (Novák & Popesko, 2014). Variable costing, on the other hand, concentrates entirely on the variable costs of production, while recognizing fixed expenditures as period expenses (Pong & Mitchell, 2006). These costing methodologies differ greatly in how fixed expenses are assigned and can have a considerable impact on a company's reported earnings. This report assesses Swipe50 Limited's profit statements for the months of February and March using both absorption costing and variable costing, highlighting the distinctions and the usefulness of each approach in financial analysis and decision-making. Recommendations on how Swipe 50 should improve its accounting systems is made. Lastly, an assessment on the essence of managerial accounting in manufacturing industries is made.

Profit Statements Using Absorption Costing and Variable Costing

Absorption costing is an accounting strategy for allocating expenses to products or services. It is also known as comprehensive costing or traditional costing. Absorption costing assigns variable and constant production costs to items, giving it a more thorough method than variable costing (Novák & Popesko, 2014).

The concept behind absorption costing is that all costs associated with producing a product should be included in its cost. This includes direct materials, direct labor, and both variable and fixed manufacturing overhead costs. Variable manufacturing costs change in relation to the level of production, while fixed manufacturing costs remain constant regardless of the level of production (Drury, 2018). By allocating fixed manufacturing costs to products, absorption costing aims to spread these costs across all units produced. This approach assumes that fixed costs are necessary to support the production process and should be part of the product's cost.

Profit statement for Swipe50 Limited for the month of February		
Sales (11, 500 units x £ 22)		£ 253,000
Direct Labor	£ 19,000	
Direct materials	£ 29,000	
Variable production overhead	£ 7,300	
Fixed Production overhead	£ 28, 600	
The total cost of manufacturing	**£ 83, 900**	
Inventory at the start of the month	0	
Less the cost of the remaining inventory at the end of the month (1000 units x 6.712)	(£ 6,712)	
Cost of goods sold:	£ 77,188	
Less the total cost of goods sold from the sales made		(£ 77,188)
Gross Profit		£ 175, 812
Less the Total Selling and administrative expenses		(£ 44,500)
Net Profit		**£ 131, 312**

Profit statement for Swipe50 Limited for the month of March		
Sales (11, 500 units x £ 22)		£ 341,000
Direct Labor	£ 22,000	
Direct materials	£ 33,250	
Variable production overhead	£ 8,500	
Fixed Production overhead	£ 28, 600	
The total cost of manufacturing	**£ 92, 350**	
Inventory at the start of the month	£ 6,712	
Less the cost of the remaining inventory at the end of the month (1000 units x 6.712)	0	
Cost of goods sold:	£ 99,062	
Less the total cost of goods sold from the sales made		(£ 99,062)
Gross Profit		£ 241, 938
Less the Total Selling and administrative expenses		(£ 57, 100)
Net Profit		**£ 184, 838**

Variable Costing

Variable costing is a method of accounting that focuses solely on the variable costs of producing a product or providing a service (Pong & Mitchell, 2006). It deducts fixed manufacturing costs from the product cost and instead treats them as period expenses. Only costs that directly fluctuate with the level of production are evaluated in variable costing. These are known as variable costs because they vary according to the number of units produced or the level of activity (Hasan, 2015).

Fixed manufacturing costs, such as rent, manager pay, and machinery depreciation, are not ascribed to products under variable costing. Instead, they are classified as period expenses and are fully deducted from the company's income in the period in which they occur. These expenditures are not thought to be directly generated by the manufacture of specific units and so are not assigned to the products.

The fundamental advantage of variable costing is that it allows for a better knowledge of contribution margins and particular product profitability. Variable costing separates fixed costs from product costs, allowing managers to focus on the incremental costs and profits associated with each unit produced (Hasan, 2015). This data can be used to make decisions, set prices, and assess the profitability of various products or services.

Profit statement for Swipe50 Limited for the month of February		
Sales (11, 500 units x £ 22)		£ 253,000
variable Labor used (11,500/12500*19000)	£ 17,480	
Variable materials used (11,500/12500*29000)	£ 26,680	
Variable production overhead (11,500/12500*7300)	£ 6,716	
Variable selling and admin cost	36225	87, 101
Contribution Margin		165, 899
Fixed prod overhead cost	28, 600	
fixed and selling and administration costs	8275	36,875
Net Profit		£ **129,024**

Profit statement for Swipe50 Limited for the month of March		
Sales (15, 500 units x £ 22)		£ 341,000
variable Labor used (15,500/14500*22000)	£ 23,540	
Variable materials used (14,500/12500*33250)	£ 35,578	
Variable production overhead (11,500/12500*7300)	£ 9,095	
Variable selling and admin cost	48,825	117,038
Contribution Margin		223,962
Fixed Production overhead	£ 28, 600	
Fixed S&A costs	8275	36,875
Net Profit		**£ 187,087**

Reconciliation

February

Net Income (Absorption Costing)	£ 131, 312
Add the fixed Production Overhead in the initial inventory	-
Total	£ 131, 312
Less Fixed Production Overhead in End. Inventory	(£ 2,288)
Net Income (variable costing	**£ 129, 024**

March

Net Income (Absorption Costing)	£ 184,838
Add the fixed Production Overhead in the initial inventory	(£ 2,288)
Total	£ 187, 126
Less Fixed Production Overhead in End. Inventory	
Net Income (variable costing	**£ 187,126**

Differences Between Absorption and Variable Accounting

Absorption costing and variable costing are two product cost accounting strategies that organizations use to allocate and account for manufacturing costs (Cotter, 2021). While both

techniques have advantages and disadvantages, they differ dramatically in how fixed costs are assigned hence differing in the influence they have on a company's stated earnings. This section entails an assessment of fixed and variable costing, their importance, and how they differ.

Absorption costing is a product costing method that assigns all costs spent during production to the product (Drury, 2018). Direct materials, direct labor, variable overheads, and fixed overheads are examples of such. Fixed overhead costs are often allocated based on a predetermined overhead rate and are allocated based on the volume of output produced (Drury, 2018). Fixed overhead expenditures are considered a cost of production under absorption costing hence the reason they are included in the cost of goods sold. When a unit is sold, a portion of the fixed overhead cost is also expensed, resulting in a reduced reported profit.

Variable costing, on the other hand, only focuses on variable costs which are costs that a company incurs per unit produced (Cotter, 2021). For instance, if one more unit is produced, the cost increases. Examples of variable costs include direct materials, direct labor, and variable. Fixed overhead costs are not included in the cost of products sold, resulting in a greater reported profit than absorption costing when calculating using the variable costing technique.

Importance of Absorption Costing

There are several benefits to using the absorption costing technique to determine the cost of a product. The importance is evidenced by the wide range of information it provides the accounting department and the organization at large. For instance, the absorption technique enables an organization to meet the reporting standards, conduct probability analysis, determine costs and plan for the future (Drury, 2018).

Absorption costing is a comprehensive approach to cost assessment that takes into account both variable and fixed production costs. It accounts for direct materials, direct labor, and manufacturing overheads, providing a more realistic picture of the true cost of producing goods or services. This data is extremely useful for price decisions, profitability analysis, and general financial management (Gupta et al., 2010).

Furthermore, absorption costing guarantees that generally recognized accounting rules (GAAP) and international financial reporting standards (IFRS) are followed (Soderstrom & Sun, 2007). Companies must allocate fixed production overhead costs to items as inventory and recognize them as expenses when the goods are sold under these rules. Businesses can comply with these reporting standards by using absorption costing, which ensures financial statement openness and comparability.

Another benefit of absorption costing is its capacity to provide a fair and realistic inventory evaluation (Baxter, 2005). Absorption costing guarantees that inventory values accurately represent the full cost of production by integrating all production expenses into the cost of goods sold. This is especially true for financial statements, tax purposes, and circumstances like mergers, acquisitions, or divestitures.

Absorption costing enables firms to properly measure the profitability of individual goods, product lines, or business divisions (Drury, 2018). Absorption costing evaluates the full burden of all resources used in the production process by attributing fixed manufacturing overhead costs to products. This enables firms to determine which goods or segments are most profitable and make strategic decisions appropriately. By removing fixed overhead costs from product costs, alternative costing methodologies, such as variable costing, may mislead profitability calculations.

The role of absorption costing extends beyond profitability analysis to decision-making and pricing strategies (Drury, 2018). By incorporating fixed overhead costs, organizations can determine the minimum acceptable selling price for a product or service, ensuring that all costs are covered, including both variable and fixed expenses. This information helps in setting competitive yet profitable prices and avoiding underpricing that can erode profitability over the long term. Moreover, absorption costing provides valuable insights into cost behavior, helping businesses identify cost drivers and manage costs more effectively.

Furthermore, absorption costs are critical in long-term planning and budgeting (Lakmal, 2014). It delivers a comprehensive cost picture by spreading fixed production overhead expenses across all units produced. Businesses can use this to forecast future expenses and estimate the resources needed for expansion, new product development, or process improvement activities. The comprehensive cost analysis also aids capital budgeting decisions by taking into account the long-term influence on product costs and profitability.

Importance of Variable Costing

The variable costing technique makes use of contribution margin analysis to determine the cost of a product (Hansen et al., 2022). The technique separates the variable and fixed costs hence coming up with the contribution margin which is the difference between the sales revenue and variable cost. Therefore, an organization’s management can make sound decisions once about pricing and allocation of resources once they understand the contribution margin.

Furthermore, cost-volume-profit (CVP) analysis makes excellent use of variable costing (Hansen et al., 2022). The links between sales volume, costs, and profit are investigated through

CVP analysis. Organizations can evaluate the effects of volume variations on profitability by concentrating on variable expenses that change in direct proportion to changes in production or sales volume. The breakeven point, the safety margin, and decisions on pricing, cost management, and capacity planning are all aided by this approach.

Variable costs are important in decision-making and pricing strategies (Drury, 2018). Organizations can evaluate the incremental costs involved with producing additional units by considering solely variable costs in product costing. This data assists in determining pricing that covers incremental costs and contribute to profitability. Businesses can correctly measure the profitability of special orders, pricing discounts, or variations in production levels thanks to variable costing hence making it easier to identify cost-cutting opportunities and assess the financial effect of various choice alternatives.

In addressing short-term variability, variable costing proves to be quite important. This costing method offers a more accurate depiction of costs during times of shifting demand, production quantities, and resource utilization. Organizations can concentrate on the costs that are most immediately impacted by changes in production or sales volume by eliminating fixed costs from product costs hence making it possible to modify production rates, control inventories, and act quickly in response to transient changes in market circumstances.

Systems for performance reviews and incentive programs are also situations whereby variable costing can be applied (Drury, 2018). Organizations can assess the success of people, departments, or business units based on their capacity to control variable costs by separating fixed expenses from product costs. This strategy increases efficiency in cost management and the awareness of costs. The development of incentive programs that honor individuals or groups for hitting cost-cutting goals, boosting output, or raising sales volumes is made easier with the help of variable costing.

Additionally, variable costing focuses administrative attention on efforts to limit costs. The exclusion of fixed costs from product costs encourages managers to carefully examine and control variable costs. By using this strategy, firms may better manage variable expenses, hence increasing cost effectiveness, spot cost-cutting possibilities, and boosting overall profitability. Managers are encouraged to optimize resource use, streamline procedures, and carry out continuous improvement projects using variable costing.

Limitations of Absorption Costing

Despite its extensive use, absorption costing has some limits that businesses must be aware of in order to make wise choices and, where necessary, take into account other costing strategies.

For accurate cost analysis and efficient financial management, it is essential to be aware of these constraints. The main restrictions on absorption costing are the application of established rates or allocation bases for the allocation of fixed overhead expenses to products. This method makes the assumption that the consumption of fixed overhead resources and the allocation base (such as direct labor hours or machine hours) are directly related. In actuality, though, this relationship might not be linear hence resulting in incorrect cost allocation.

The possibility for distortion in profitability analysis is yet another drawback of absorption costing (Ruiz-de-Arbulo-Lopez et al., 2013). Products with high production volumes typically contain a bigger proportion of fixed costs, giving them the appearance of being more lucrative when production quantities vary dramatically or the manufacturing mix varies. Lower-volume products, on the other hand, would appear to be less profitable. As a result, inaccurate judgments regarding the actual profitability of particular goods or business niches may be drawn.

Absorption costing may also make it difficult to value inventory (Fisher & Krumwiede, 2015). Production volume may have an impact on valuation since inventory is allocated fixed overhead expenses. In times of low output, each inventory unit receives a bigger share of fixed expenses per unit hence leading to overvaluation. In contrast, during times of strong output, the fixed costs are divided among many units, leading to undervaluation. This may have an effect on financial statements, tax computations, and inventory management decisions.

Absorption costing may also pose difficulties in cost control efforts, particularly concerning fixed overhead costs. Since fixed costs are allocated to products regardless of actual usage, managers may have limited control over the amount of fixed costs assigned to their products. This can reduce the incentive to manage and control fixed costs, potentially hindering cost-reduction initiatives and overall cost-control effectiveness.

Furthermore, absorption costing may be incompatible with activity-based costing (ABC). ABC focuses on connecting costs to activities and cost drivers in order to deliver more accurate cost information. Absorption costing, on the other hand, is based on arbitrary allocation bases that may or may not correlate with the comprehensive and activity-driven cost information offered by ABC hence failing to accurately reflect the more detailed cost behavior analysis provided by ABC in firms that use it.

Finally, the inability of absorption costing to always offer the most pertinent cost data for pricing decisions creates the risk of management making a misinformed judgment. The expenses incurred when producing extra units or the actual cost behavior of products may not

be correctly reflected by including fixed overhead costs in product costs. In circumstances where variable costs are the main causes of cost variations, this may result in less-than-ideal judgments.

Limitations of Variable Costing

Insufficient cost recovery is a key drawback of variable costing. Fixed overhead costs are treated as period costs in variable costing rather than being allocated to goods (Novak et al., 2016). Products might not cover their fair share of fixed costs as a result hence the likelihood of misleading a profitability analysis. Decision-making may be impacted by this constraint, which also makes it difficult to evaluate the actual profitability of specific products.

Variable costing also disregards the effect of variations in production volume on fixed costs (Ratnasih & Sulbahri, 2022). It takes neither underutilization nor overutilization of manufacturing capacity into account. As a result, regardless of production volume, fixed costs stay constant, potentially leading to incorrect cost-per-unit estimations. This limitation may have an impact on pricing, capacity planning, and determining profitability at various production levels. With variable costing, financial reporting might become more complicated. External financial statements frequently demand absorption costing, which may necessitate the conversion of variable costing data. This conversion procedure can be time-consuming and error-prone, resulting in inconsistencies in financial reporting.

Variable costing can complicate performance evaluations, especially when dealing with different product lines or company segments (Ratnasih & Sulbahri, 2022). Without allocating fixed expenses to items, determining the profitability of individual products or segments becomes difficult thus having an impact on product mix optimization, resource allocation, and performance-based incentive systems. The absence of fixed costs from product costs in variable costing may result in a limited focus on monitoring and controlling fixed costs. Managers may focus exclusively on variable costs, which can stymie efforts to effectively control fixed costs and lead to missed cost-cutting possibilities.

Variable costing and absorption costing are two different approaches to costing and may yield different results. This incompatibility poses challenges when comparing financial statements prepared using different costing methods or integrating cost data from various sources hence the need to carefully reconcile variable costing with absorption costing data.

Recommendations for Improving Swipe's Accounting System

Despite Swipes being operational for three years, there are several ways in which it can improve its accounting systems. As a company grows, it is essential to improve its accounting systems

to ensure it manages the growth effectively. This section entails recommendations for how Swipes can improve its accounting system.

Implement an ERP System

Implementing an Enterprise Resource Planning (ERP) system is one of the most effective strategies for Swipes 50 Ltd. to improve its accounting procedures. A comprehensive software solution that integrates all of a company's business activities, such as accounting, finance, human resources, manufacturing, and supply chain management, is known as an ERP system (Spathis & Constantinides, 2004). Swipes 50 Ltd. can improve its accounting operations in a variety of ways by installing an ERP system as it grows hence making the accounting processes more accurate and effective.

For instance, an ERP system can automate numerous manual accounting operations, such as accounts payable and receivable thus saving the organization time and reducing the possibility of errors (Spathis & Constantinides, 2004). Furthermore, an ERP system can provide real-time financial data, allowing the organization to make more educated decisions. Finally, an ERP system can give a company more visibility into its financial performance, allowing it to discover areas where it can cut expenses and boost profitability hence making it easy to make changes to improve the processes.

Develop a Cash Flow Forecasting System

Swipes 50 Ltd. can also improve its accounting systems by developing a cash flow forecasting system. Cash flow forecasting is the process of estimating a company's cash inflows and outflows over a given time period. Building a cash flow forecasting system can potentially improve Swipe's accounting systems in various ways. A cash flow forecasting system can assist the organization in identifying possible cash flow issues before they arise hence enabling the company to take corrective action (Nikkinen & Sahlström, 2004). A cash flow forecasting system can also assist the organization in optimizing its cash management by ensuring that it has adequate cash on hand to meet its obligations thus reducing the risk of liquidity challenges (Nikkinen & Sahlström, 2004). When Swipe starts using a cashflow forecasting system, the management will be in a position to make better future investment decisions.

Improve Cost Accounting Systems

Finally, Swipes 50 Ltd.'s accounting systems can be improved by upgrading its cost accounting systems. Cost accounting is the process of tracking and assessing the expenses of producing a product or service. Swipes 50 Ltd. can improve its accounting systems in a variety of ways by upgrading its cost accounting systems. The firm will have a better awareness of the expenses associated with producing its products thanks to improved cost accounting systems (Watts et

al., 2014). As a result, it will help the company find chances for cost-cutting, such as optimizing production processes or negotiating better supplier rates. Additionally, improved cost accounting systems will give the business the ability to make better pricing decisions, ensuring that it prices its products competitively while still earning a profit. Finally, improved cost accounting systems can help the business determine which of its goods are the most profitable, allowing it to concentrate on those and drop the less successful ones.

Any business that intends to guarantee that its financial information is accurate, timely, and relevant must improve its accounting processes (Watts et al., 2014). By establishing an ERP system, creating a cash flow forecasting system, and enhancing its cost accounting systems, Swipes 50 Ltd. can enhance its accounting processes hence incorporating the accounting demands of the growing organization. Thus, the business can enhance its financial performance and make more knowledgeable business judgments.

Managerial Accounting Jobs

In a manufacturing company, managing accounting positions are essential for a number of reasons. In order to survive and be profitable, manufacturing companies must function in an environment that values productivity, cost-effectiveness, and resource management and control. Therefore, these businesses can plan for future growth and expansion, discover inefficiencies, reduce waste, and make educated decisions thanks to having a robust accounting function.

Cost Control and Financial Management

Cost management and financial management both heavily rely on accounting jobs. Direct materials, direct labor, overhead expenditures, and other expenses are some of the costs that need to be managed in a manufacturing business. These costs must be tracked and monitored, inefficiencies must be found, and cost-cutting measures must be put in place, all by the accounting department (Weygandt, 2020). The business can raise its profitability and market competitiveness by doing this.

Compliance with Regulations

Management accounting jobs are essential in manufacturing companies since they help the company to comply with several regulations (Albu et al., 2011). Manufacturing companies have to adhere to several regulations which include tax obligations, labor laws, and environmental laws. Through conducting analysis and deriving several reports, managerial accountants enable the firm to comply and make informed decisions.

Strategic Planning and Decision Making

Strategic planning and decision-making are important to long-term success in a manufacturing organization. Accounting provides financial data that is utilized to make sound judgments about investments, capital expenditures, and other strategic activities (Mihăilă, 2014). The accounting department may assist the organization in identifying areas of opportunity and evaluating the possible risks and rewards of various courses of action hence facilitating sound decision-making for the company.

Inventory Management

Manufacturing firms have a huge inventory, which represents a significant investment. Proper inventory management is critical for avoiding stockouts, lowering carrying costs, and ensuring that the company has enough raw materials and finished goods to meet customer demand. Accountants are in charge of maintaining inventory levels, valuing goods, and reconciling inventory balances (Weygandt, 2020). Therefore, accountants can improve the company's inventory hence mitigating the risk of overstocking or stock shortages which can chase away customers.

Performance Measurement and Reporting

For a manufacturing company to monitor its financial health and pinpoint opportunities for improvement, performance measurement, and reporting are crucial. Financial statements, such as income statements, balance sheets, and cash flow statements, are created by the accounting department (Hall, 2008). The corporation can assess its financial performance, spot areas of weakness, and take corrective action by examining these statements.

A manufacturing company's performance depends on managing accounting positions (Hall, 2008). The accounting division offers crucial financial data needed to control expenses, adhere to rules, make wise decisions, improve inventory control, and keep track of performance. Manufacturing organizations can increase their productivity, profitability, and market competitiveness by putting money into a good accounting function (Hall, 2008).

Conclusion

The choice between absorption costing and variable costing holds the key to unlocking a company's financial insights. These two methods provide distinct perspectives on cost allocation, allowing organizations to make informed decisions that drive profitability and growth. Absorption costing, with its comprehensive approach, paints a full picture by considering both variable and fixed costs. It aligns with external reporting requirements, offering a holistic view of production expenses. On the other hand, variable costing focuses solely on variable costs, providing internal decision-makers with direct insights into the costs

directly tied to production. Selecting the appropriate costing method depends on the organization's goals and needs. Absorption costing suits external reporting purposes, while variable costing empowers internal decision-making, especially when analyzing profitability or evaluating changing fixed costs. Swipes should implement Enterprise Resource Planning (ERP) systems, develop a cash flow forecasting system to improve its accounting systems. Lastly, the managerial accounting profession plays a significant role in ensuring manufacturing organizations operate smoothly.

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