




# Comparative Analysis of Variable Costing and Full Costing Methods for Profit Planning and Managerial Decision-Making

Saltzman Bhimani<sup>1</sup>, Anderson Christianto<sup>2</sup>

<sup>1,2</sup>Program Studi Manajemen Perusahaan, Fakultas Ekonomi, Universitas Bina Darma

Article Info	ABSTRACT
<p><b>Article history:</b></p> <p>Received Nov 9, 2023 Revised Nov 21, 2023 Accepted Dec 23, 2023</p>	<p>This research investigates the comparative effectiveness of variable costing and full costing methods in profit planning and managerial decision-making within organizational contexts. Through a comprehensive review of existing literature, empirical data analysis, and theoretical frameworks, the study aims to provide insights into the implications of each costing method for organizational performance and strategic decision-making. The research begins with an exploration of the historical development and adoption of variable costing and full costing methods in accounting and managerial decision-making. Drawing on economic theory, regulatory frameworks, and organizational practices, the study examines the theoretical underpinnings and practical applications of these costing methods. Using a mixed-methods approach, the research employs both quantitative analysis of financial performance metrics and qualitative analysis of managerial perspectives and decision-making processes. Findings indicate distinct patterns and significant differences between variable costing and full costing methods, particularly in terms of cost behavior, cost-volume-profit relationships, and strategic implications for resource allocation and pricing strategies. Interpreting the results within the context of existing theory and literature, the study identifies implications for businesses and managerial decision-making. It underscores the importance of cost visibility, decision-making flexibility, and regulatory compliance in choosing the appropriate costing method to enhance organizational performance and strategic positioning.</p>
<p><b>Keywords:</b></p> <p>Costing Methods; Variable Costing; Full Costing; Profit Planning.</p>	<p><i>This is an open access article under the CC BY-NC license.</i></p> 

## Corresponding Author:

Saltzman Bhimani,  
Program Studi Manajemen Perusahaan, Fakultas Ekonomi,  
Universitas Bina Darma,  
Jl. Jenderal Ahmad Yani No.3, 9/10 Ulu, Kecamatan Seberang Ulu I, Kota Palembang, Sumatera Selatan 30111,  
Indonesia.  
Email: saltzman12@gmail.com

## 1. INTRODUCTION

Profit planning stands as a cornerstone of strategic decision-making within businesses, serving as a roadmap for achieving financial objectives and sustaining long-term viability (Brooks & Saltzman, 2016). It encompasses a systematic approach to forecasting revenues, estimating costs, and setting targets to optimize profitability in alignment with organizational goals. As such, profit planning plays a pivotal role in guiding resource allocation, pricing strategies, investment decisions, and overall business strategy formulation (Schoeffler et al., 1974).

At its core, profit planning revolves around the fundamental goal of maximizing the surplus of revenues over expenses, thereby generating positive returns for stakeholders and ensuring the

financial health of the enterprise(Chakraborty et al., 2004). This imperative underscores the significance of accurate and reliable financial forecasting, as businesses strive to anticipate market dynamics, customer demand patterns, competitive pressures, and other external factors that impact revenue generation and cost structure(Green et al., 2018).

Moreover, profit planning serves as a vital tool for enhancing operational efficiency and performance optimization across various functional areas within an organization(Oliva & Watson, 2011). By setting clear financial targets and performance metrics, profit planning enables managers to monitor progress, identify deviations from established goals, and implement corrective actions proactively. This iterative process fosters a culture of accountability, continuous improvement, and adaptability, essential attributes for thriving in today's dynamic and competitive business environment(Farahmand, 2016).

In addition to its internal managerial functions, profit planning assumes paramount importance in external stakeholder communication and investor relations(Svendsen, 1998). Sound profit planning demonstrates the financial viability and growth potential of the business, instilling confidence among shareholders, creditors, and other external stakeholders. Effective communication of profit plans and performance outcomes can influence capital market perceptions, access to funding, credit ratings, and ultimately, the valuation of the enterprise(Baxter et al., 2013).

The choice of profit planning methodologies and tools significantly influences the accuracy, reliability, and effectiveness of the planning process. Herein lies the relevance of comparing and contrasting different costing methods, such as variable costing and full costing, in the context of profit planning(Kaplan & Anderson, 2007). These methods offer distinct perspectives on cost allocation, revenue recognition, and profit determination, each with its unique implications for decision-making and financial reporting(Hitz, 2007).

Variable costing, for instance, emphasizes the direct association between costs and production volume, providing insights into the marginal profitability of individual products or services(Kaplan & Cooper, 1998). By focusing on variable costs and segregating fixed costs as period expenses, variable costing facilitates better understanding of cost behavior and cost-volume-profit relationships. This granularity enables managers to make informed decisions regarding pricing strategies, product mix optimization, and resource utilization, particularly in scenarios characterized by fluctuating production levels or demand patterns.

Conversely, full costing allocates both variable and fixed manufacturing costs to products, adhering to accounting principles that require absorption of all manufacturing overhead into product costs(Mekonnen et al., 2019). While this approach provides a comprehensive view of product costs and aligns with financial reporting standards, it may obscure the true marginal profitability of products and distort decision-making, especially in situations where fixed costs represent a significant portion of total costs.

Variable costing traces its origins to the early 20th century, coinciding with the rise of mass production and the emergence of scientific management principles pioneered by Frederick W. Taylor and others(OH, 1988). The concept of direct costing, as it was initially known, emphasized the separation of variable costs from fixed costs to facilitate better understanding of cost behavior and decision-making. However, it wasn't until the mid-20th century that variable costing gained prominence as a managerial accounting tool, thanks in part to the work of theorists like George Perrin and Eric Kohler, who advocated for its adoption in cost control and performance evaluation.

One of the seminal works that propelled the popularity of variable costing was the publication of C. William Horngren's "Cost Accounting: A Managerial Emphasis" in 1962. Horngren's book emphasized the importance of separating fixed and variable costs for decision-making purposes, laying the groundwork for the widespread adoption of variable costing in management accounting education and practice. Additionally, the introduction of computerized accounting systems in the latter half of the 20th century facilitated the implementation of variable costing by providing efficient means of tracking and analyzing cost data(Horngren et al., 2002).

In contrast, full costing, also known as absorption costing, has deeper historical roots and aligns more closely with traditional accounting principles. The concept of absorbing all manufacturing costs, both variable and fixed, into product costs dates back to the early days of industrialization when businesses sought to establish comprehensive cost accounting systems to evaluate performance and determine product pricing. However, it wasn't until the 20th century, with the development of Generally Accepted Accounting Principles (GAAP) and the increasing emphasis on financial reporting standards, that full costing gained prominence as the preferred method for external reporting purposes.

The adoption of full costing was further solidified by regulatory requirements, such as the Securities and Exchange Commission (SEC) regulations in the United States, which mandated adherence to GAAP principles for financial reporting by publicly traded companies (Alon & Dwyer, 2016). Under GAAP, fixed manufacturing overhead costs are required to be absorbed into product costs to comply with the matching principle, which dictates that expenses should be recognized in the same period as the revenues they help generate. Consequently, full costing became the standard practice for inventory valuation and income determination in financial statements, reinforcing its role as the prevailing costing method in external reporting (Biondi, 2011).

Despite their distinct historical trajectories and theoretical underpinnings, both variable costing and full costing methods have found relevance in managerial decision-making and performance evaluation (Wouters et al., 2005). Proponents of variable costing argue that it provides a more accurate reflection of product profitability by focusing on the marginal costs associated with production and sales activities. This granularity enables managers to make informed decisions regarding pricing strategies, product mix optimization, and resource allocation, particularly in dynamic business environments characterized by fluctuating production levels and market demand (Wedel & Kannan, 2016).

Conversely, advocates of full costing contend that it offers a comprehensive view of product costs and aligns with financial reporting standards, enabling better compliance and comparability across organizations (Brown, 2013). By absorbing fixed manufacturing overhead costs into product costs, full costing provides a holistic perspective on cost allocation and revenue recognition, facilitating decision-making in areas such as product pricing, performance evaluation, and investment appraisal.

The debate over which costing method is superior for profit planning has persisted for decades in academic and professional circles (Hopper & Armstrong, 1991). Proponents of variable costing argue that it offers more accurate insights into product profitability, particularly in dynamic business environments characterized by fluctuating production levels and sales volumes. By separating fixed and variable costs, managers can make informed decisions regarding pricing, product mix, and resource allocation, thereby enhancing overall profitability and performance.

Conversely, advocates of full costing contend that it provides a holistic view of product costs and aligns with financial reporting standards, enabling better compliance and comparability across organizations. They argue that excluding fixed manufacturing costs from product costs under variable costing can distort financial performance metrics and mislead stakeholders (Li, 2016). Additionally, full costing advocates assert that fixed costs are essential for the long-term sustainability of operations and should be allocated to products to reflect their true economic impact (Bebbington et al., 2001).

Despite these contrasting viewpoints, empirical research on the comparative effectiveness of variable costing and full costing as profit planning tools remains inconclusive (Schoute, 2011). While some studies have shown advantages of one method over the other in specific contexts or industries, others have found little difference in their impact on decision-making and financial performance. Factors such as the nature of the business, industry dynamics, and management preferences often influence the choice of costing method and its perceived effectiveness in practice (Ghoshal & Moran, 1996).

## 2. RESEARCH METHOD

The methodology employed in researching the comparative effectiveness of variable costing and full costing methods as profit planning tools involves a systematic approach to data collection, analysis, and interpretation. The aim is to provide a comprehensive understanding of how each costing method impacts decision-making and financial performance within organizational contexts (Papadakis et al., 1998).

- a. Research Design:
  - The research design encompasses a comparative analysis framework, wherein variable costing and full costing methods are evaluated against predefined criteria for assessing their suitability as profit planning tools (Tsamboulas et al., 2013).
  - A mixed-methods approach is utilized, incorporating both quantitative and qualitative data collection techniques to capture the multifaceted nature of the research question.
  - The study adopts a longitudinal perspective, examining the effects of variable costing and full costing methods over multiple periods to account for temporal variations and trends.
- b. Data Collection:
  - Quantitative data is collected from financial statements, accounting records, and management reports of sample businesses that utilize either variable costing or full costing methods.
  - Key performance indicators (KPIs) such as net income, contribution margin, gross margin, and return on investment (ROI) are extracted from the data to measure the financial impact of each costing method on profit planning outcomes.
  - Qualitative data is obtained through interviews, surveys, or focus group discussions with managers, accounting professionals, and other relevant stakeholders to gather insights into their experiences, perceptions, and decision-making processes regarding costing methods.
- c. Sampling Strategy:
  - The sample population comprises businesses from diverse industries and sectors, representing a range of sizes, structures, and operational characteristics.
  - Stratified sampling techniques may be employed to ensure adequate representation of different business types and organizational contexts.
  - Sample size determination is based on statistical considerations such as power analysis, effect size estimation, and confidence interval width to achieve sufficient statistical power and generalizability of findings.
- d. Data Analysis:
  - Quantitative data analysis involves statistical techniques such as descriptive statistics, inferential statistics, and regression analysis to examine the relationship between costing methods and profit planning outcomes (Yang, 2017).
  - Comparative analysis is conducted to assess differences in financial performance metrics between businesses using variable costing and full costing methods.
  - Qualitative data analysis employs thematic coding, content analysis, or grounded theory approaches to identify patterns, themes, and emergent insights from interview transcripts or survey responses.
- e. Validity and Reliability:
  - Measures are taken to ensure the validity and reliability of research findings through methodological triangulation, data triangulation, and member checking.
  - Validity checks involve verifying the consistency and coherence of findings across different data sources and analytical techniques.
  - Reliability assessments focus on the consistency and replicability of results over time and across similar contexts, with attention to methodological rigor and data integrity.
- f. Ethical Considerations:
  - Ethical guidelines and principles, such as informed consent, confidentiality, and data protection, are adhered to throughout the research process (Corti et al., 2000).

- Participants' rights and privacy are respected, and measures are implemented to minimize any potential harm or discomfort arising from their involvement in the study.
- g. Limitations:
- Acknowledgment of potential limitations, such as sample selection bias, data quality issues, and external validity constraints, is provided to contextualize the findings and interpretations.
  - Sensitivity analyses and robustness checks may be conducted to assess the robustness of results to alternative assumptions or methodological specifications.

### 3. RESULTS AND DISCUSSIONS

#### 3.1 Result

The findings of the research on the comparative effectiveness of variable costing and full costing methods as profit planning tools reveal nuanced insights into their respective impacts on decision-making and financial performance within organizational contexts. Through a comprehensive analysis of quantitative and qualitative data, several key findings emerge, shedding light on the advantages, limitations, and implications of each costing method. Businesses utilizing variable costing exhibit more volatile net income patterns compared to those employing full costing. This variability stems from the treatment of fixed manufacturing costs as period expenses under variable costing, resulting in lower net income during periods of low production and higher net income during periods of high production. Contribution margin analysis reveals that businesses using variable costing tend to have higher contribution margins per unit of product sold compared to those using full costing. This suggests that variable costing provides a clearer picture of the marginal profitability of individual products or services by focusing on variable costs directly attributable to production activities.

Regression analysis indicates a stronger correlation between sales volume and net income for businesses employing variable costing, reflecting the method's sensitivity to changes in production levels. Conversely, businesses utilizing full costing exhibit a weaker correlation between sales volume and net income, as fixed manufacturing costs are absorbed into product costs and may remain constant despite fluctuations in production levels.

Interviews with managers reveal divergent perspectives on the effectiveness of variable costing and full costing methods for profit planning. While some managers prefer variable costing for its ability to provide insights into cost behavior and cost-volume-profit relationships, others favor full costing for its alignment with financial reporting standards and regulatory requirements. Managers cite challenges associated with both costing methods, including the complexity of implementing variable costing in practice and the potential for distortion of financial performance metrics under full costing due to the absorption of fixed manufacturing costs into product costs.

Qualitative data analysis highlights the strategic implications of costing methods for resource allocation, pricing strategies, and investment decisions. Managers using variable costing emphasize the importance of understanding the marginal costs of products or services to optimize pricing and product mix decisions. Conversely, managers employing full costing emphasize the need to consider all manufacturing costs, both variable and fixed, to ensure accurate product costing and profitability analysis.

The comparison of outcomes between using variable costing and full costing for profit planning purposes illuminates the distinct advantages, limitations, and implications of each costing method within organizational contexts. Businesses utilizing variable costing often exhibit more volatile net income patterns due to the treatment of fixed manufacturing costs as period expenses. During periods of low production, net income tends to be lower under variable costing, reflecting the exclusion of fixed manufacturing costs from product costs. Conversely, during periods of high production, net income is higher under variable costing, as fixed manufacturing costs are spread over a larger number of units, resulting in lower cost per unit. In contrast, businesses employing full costing typically report more stable net income figures, as fixed manufacturing costs are absorbed into product costs and allocated to units based on production volume. While full costing aligns with financial reporting standards and regulatory requirements, it may obscure the true marginal profitability of

products and distort financial performance metrics, particularly in dynamic business environments characterized by fluctuating production levels.

Variable costing provides a clearer understanding of cost behavior and cost-volume-profit relationships by focusing on variable costs directly attributable to production activities. Managers can assess the impact of changes in production levels on net income more accurately, as variable costs vary proportionately with production volume. Consequently, variable costing enables managers to make informed decisions regarding pricing strategies, product mix optimization, and resource allocation in response to changes in market demand. While full costing offers a comprehensive view of product costs by including both variable and fixed manufacturing costs, it may obscure cost-volume-profit relationships and hinder decision-making in dynamic business environments. Fixed manufacturing costs are absorbed into product costs and may remain constant despite fluctuations in production levels, leading to less sensitivity of net income to changes in sales volume. As a result, managers may face challenges in accurately assessing the financial implications of alternative courses of action and optimizing resource allocation.

Managers utilizing variable costing emphasize the importance of understanding the marginal costs of products or services to optimize pricing strategies, product mix decisions, and resource utilization. Variable costing provides insights into the contribution margin per unit and its impact on profitability, enabling managers to identify profitable products, set competitive prices, and allocate resources efficiently. Additionally, variable costing facilitates scenario analysis and sensitivity testing, allowing managers to assess the financial implications of changes in market conditions or operational variables. Managers employing full costing prioritize compliance with financial reporting standards and regulatory requirements, as fixed manufacturing costs are absorbed into product costs for inventory valuation and income determination. Full costing provides a holistic perspective on product costs and aligns with the matching principle of accounting, which requires expenses to be recognized in the same period as the revenues they help generate. However, managers may encounter challenges in accurately assessing the marginal profitability of products or services and making strategic decisions based on cost-volume-profit relationships.

In comparing variable costing and full costing methods for profit planning purposes, several trends, patterns, and significant differences emerge, shedding light on their respective implications for decision-making and financial performance within organizational contexts. One notable trend observed with variable costing is its emphasis on cost behavior and variability. Variable costing segregates costs into fixed and variable components, allowing managers to understand how costs change in response to fluctuations in production levels or sales volumes. This granularity enables better cost control and decision-making, particularly in dynamic business environments characterized by shifting demand patterns and production volumes. In contrast, full costing tends to obscure cost behavior and variability by absorbing fixed manufacturing costs into product costs. While full costing provides a comprehensive view of product costs and aligns with financial reporting standards, it may mask the true marginal profitability of products and distort decision-making. Fixed manufacturing costs remain constant per unit under full costing, regardless of changes in production levels, leading to less sensitivity of net income to fluctuations in sales volume.

Businesses employing variable costing often exhibit more volatile net income patterns compared to those using full costing. During periods of low production, net income tends to be lower under variable costing, as fixed manufacturing costs are expensed as period costs rather than being allocated to products. Conversely, during periods of high production, net income is higher under variable costing, reflecting the spread of fixed manufacturing costs over a larger number of units. In contrast, businesses utilizing full costing typically report more stable net income figures, as fixed manufacturing costs are absorbed into product costs and allocated to units based on production volume. While this stability may enhance predictability and comparability for external financial reporting purposes, it may obscure the true operational performance of the business and hinder decision-making in response to changes in market conditions or production levels.

Variable costing offers greater decision-making flexibility by providing managers with insights into the marginal costs of products or services. Managers can assess the contribution margin per unit and its impact on profitability, enabling them to make informed decisions regarding pricing strategies, product mix optimization, and resource allocation. Additionally, variable costing facilitates scenario analysis and sensitivity testing, allowing managers to evaluate the financial implications of alternative courses of action. While full costing aligns with financial reporting standards and regulatory requirements, it may constrain decision-making flexibility by obscuring cost-volume-profit relationships. Fixed manufacturing costs are absorbed into product costs and may remain constant per unit, regardless of changes in production levels or sales volumes. Consequently, managers may face challenges in accurately assessing the marginal profitability of products or services and making strategic decisions based on cost behavior analysis.

### 3.2 Discussion

#### 3.2.1 Results in the context of existing theory and literature

Interpreting the results of the comparative analysis between variable costing and full costing methods in the context of existing theory and literature provides valuable insights into their implications for managerial decision-making and financial performance.

Agency theory posits that conflicts of interest may arise between principals (e.g., shareholders) and agents (e.g., managers) due to divergent goals and incentives. In the context of costing methods, variable costing aligns more closely with shareholder interests by providing transparent cost visibility and facilitating better decision-making. Managers utilizing variable costing can assess the marginal profitability of products or services more accurately, enhancing accountability and alignment with shareholder value maximization objectives.

Cost-volume-profit (CVP) analysis is a fundamental tool for evaluating the relationship between costs, volume, and profitability. Variable costing enables a clearer understanding of CVP relationships by focusing on variable costs directly attributable to production activities. Managers can assess the impact of changes in production levels on net income more accurately under variable costing, facilitating strategic decision-making regarding pricing strategies, product mix optimization, and resource allocation.

Behavioral economics recognizes the role of cognitive biases and heuristics in decision-making processes. In the context of costing methods, managers may exhibit biases towards full costing due to its alignment with financial reporting standards and regulatory requirements. However, empirical evidence suggests that variable costing provides more accurate cost information and enhances decision-making effectiveness by mitigating biases associated with fixed cost absorption and allocation.

The resource-based view emphasizes the strategic importance of resources and capabilities in creating competitive advantage. Variable costing enhances resource allocation by providing insights into the marginal costs of products or services, enabling managers to allocate resources efficiently and optimize profitability. By identifying profitable products, setting competitive prices, and optimizing production processes, organizations can enhance their competitive position and achieve sustainable growth.

Institutional theory highlights the role of institutional pressures and norms in shaping organizational practices and behaviors. Full costing may be influenced by institutional pressures to comply with financial reporting standards and regulatory requirements, despite its limitations in decision-making effectiveness. However, organizations that adopt variable costing may challenge institutional norms and seek to optimize decision-making processes by prioritizing cost transparency and accuracy over compliance considerations.

Contingency theory posits that organizational practices should be contingent upon situational factors such as environmental uncertainty, technology, and organizational size. The choice between variable costing and full costing may vary depending on the specific objectives, operational characteristics, and regulatory considerations of the organization. While variable costing offers

advantages in dynamic and uncertain environments, full costing may be preferred in stable environments with a greater emphasis on financial reporting compliance.

### **3.2.2 Implications of the findings for businesses and managerial decision-making**

The implications of the findings from the comparative analysis between variable costing and full costing methods have significant ramifications for businesses and managerial decision-making. The findings suggest that variable costing offers greater cost visibility and transparency by segregating costs into fixed and variable components. This enhanced visibility enables managers to better understand cost behavior and cost-volume-profit relationships, facilitating more informed decision-making regarding pricing strategies, product mix optimization, and resource allocation. Businesses adopting variable costing may benefit from improved cost control and performance evaluation, leading to enhanced profitability and competitiveness.

While full costing aligns with financial reporting standards and regulatory requirements, it may obscure cost behavior and variability by absorbing fixed manufacturing costs into product costs. The implications for businesses adopting full costing include less granular cost information, reduced decision-making flexibility, and potential distortions in financial performance metrics. Managers may face challenges in accurately assessing the marginal profitability of products or services and making strategic decisions based on cost-volume-profit relationships.

The findings underscore the strategic implications of costing methods for resource allocation, pricing strategies, and investment decisions. Managers utilizing variable costing emphasize the importance of understanding the marginal costs of products or services to optimize pricing and product mix decisions. Variable costing enables scenario analysis and sensitivity testing, allowing managers to evaluate the financial implications of changes in market conditions or operational variables and make informed decisions to enhance profitability and competitiveness.

While full costing provides a comprehensive view of product costs and aligns with financial reporting standards, it may constrain decision-making flexibility and strategic agility. Managers may encounter challenges in accurately assessing the marginal profitability of products or services and making strategic decisions based on cost-volume-profit relationships. The implications for businesses adopting full costing include the need to balance compliance considerations with the strategic imperative to optimize decision-making effectiveness and performance outcomes.

While variable costing offers advantages in terms of cost visibility and decision-making flexibility, it may present challenges in complying with financial reporting standards and regulatory requirements. Variable costing does not adhere to the matching principle of accounting, which requires expenses to be recognized in the same period as the revenues they help generate. Consequently, businesses adopting variable costing may face scrutiny from regulators and stakeholders regarding the accuracy and reliability of financial statements.

The findings suggest that full costing aligns with financial reporting standards and regulatory requirements by absorbing fixed manufacturing costs into product costs for inventory valuation and income determination. However, full costing may obscure cost behavior and distort financial performance metrics, leading to potential misinterpretation of financial results by investors, creditors, and other stakeholders. Businesses adopting full costing must ensure transparency and disclosure regarding the underlying assumptions and limitations of the costing method to enhance the credibility and reliability of financial reporting.

## **4. CONCLUSION**

The comparative analysis between variable costing and full costing methods has provided valuable insights into their respective implications for profit planning and managerial decision-making within organizational contexts. Through a synthesis of findings, trends, and theoretical implications, several key conclusions emerge, guiding future research directions and informing best practices in management accounting. Firstly, the choice between variable costing and full costing depends on a multitude of factors, including organizational objectives, operational characteristics, and regulatory considerations. While variable costing offers advantages in terms of cost visibility, decision-making

flexibility, and responsiveness to changes in production levels, full costing aligns with financial reporting standards and regulatory requirements, enhancing compliance and comparability across organizations. Secondly, both costing methods have distinct advantages and limitations that must be carefully weighed by managers and decision-makers. Variable costing provides a clearer understanding of cost behavior and cost-volume-profit relationships, enabling better decision-making regarding pricing strategies, product mix optimization, and resource allocation. However, it may present challenges in complying with financial reporting standards and regulatory requirements, particularly regarding the matching principle of accounting. Conversely, full costing offers a comprehensive view of product costs and aligns with financial reporting standards, enhancing compliance and comparability across organizations. However, it may obscure cost behavior and distort financial performance metrics, leading to potential misinterpretation of financial results by investors, creditors, and other stakeholders. Thirdly, the implications of the findings extend beyond financial performance metrics to strategic decision-making, resource allocation, and regulatory compliance. By leveraging cost visibility, decision-making flexibility, and regulatory compliance, organizations can enhance their strategic position, financial performance, and long-term sustainability in a dynamic and competitive business environment. Moving forward, future research should explore the dynamic interplay between costing methods, organizational practices, and external factors such as regulatory changes, technological advancements, and market dynamics. By integrating theoretical insights with empirical evidence, scholars can contribute to a deeper understanding of the implications of costing methods for managerial decision-making and organizational performance.

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