

ABC 'S' of Art: Lessons for Michelangelo

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Michelangelo (Mike) hung the line from one of his customers. Despair was writ large on his face. The news was not very pleasant. His customer a B2C portal: myartwork.com had placed a request. "We are unable to sell your wares at the present price, please consider a substantial revision", was the message. The portal helped rake in more than 80 percentages of Mike's revenues. Losing this client would prove suicidal.

iRis Creations:

Mike was a gifted artist, the prodigal son of a famous portrait painter Prometheus. Mike learnt the basics of art at a very early age, mostly observing his dad working on portraits. Prometheus was a classical exponent of the early tempera style of painting. His paintings bore rich hues, often 150 layers of thin color. Mike used to assist his dad in setting up the canvas and at times trying his hand at coloring insignificant parts of the canvas. Mike understood the steps involved in painting from his dad. Build the canvas, prepare the concept sketch and then perform the master coloring.

Mike grew up to graduate from the Indiana School of Art (ISA). He started iRis Creations, a company that specialized in landscape and portrait painting. During his graduate days Mike developed three simple steps to paint. A style perfected by him over the years, the process was kept simple. Paint brown undercoat on canvas, sketch a rough drawing using white color and then do the actual (master) painting. This three-step process helped him work on several paintings simultaneously, while still retaining control over critical pieces of his composition. Tasks like setting the canvas and preparing the background colors was left to trained assistants.

iRis was an instant hit with customers. Due to the encouraging response, Mike tied up with myartwork.com an online portal that promoted art. Mike found online customers more serious and cost effective because it saved him the trouble of finding them all by himself. This way Mike could cater to a wide range of customers, wealthy individuals, trade organizations, professional firms, art studios and churches.

Mike's Woes:

Myartwork.com had recently begun to feature more artists on their portal. This presented them with an expanding revenue stream because sales through the portal led to lucrative commissions. However, for artists like Mike this meant a surge in competition. With low brand loyalty and no basis for differentiation, price seemed to be the deciding factor. The CFO of myartwork.com who called Mike had this to say: "Your present portrait prices are \$20 more than competition". The price of landscapes however was \$6 lesser than competition. Though landscape paintings contributed to a major part of the company's revenues, much of these orders were generated through referrals from portrait customers.

Pricing Art:

Mike understood colors better but not numbers. Disturbed by the call from myartwork.com he convened a meeting with his Chief Accountant-Scott and Production Coordinator-Sam. He began by referring to his conversation with the portal's CFO. "Unless we do something about this, we are going to bleed", grieved Mike. "Scott, could you explain how we have been pricing our artwork so far?" he enquired.

Scott a seasoned accountant worked for the Kimberly's retail chain, prior to his association with iRis. "There are a lot of costs that need to be traced meticulously", explained Scott. "We incur costs on selection of canvas, setting up the canvas, line drawing, master sketching and background coloring. Besides we incur significant costs on the post production too like canvas waxing, fume drying and frame mounting.

Sam, who was keenly observing the conversation, broke his silence. "So, Scott how do we arrive at the price finally?" Scott recognizing the fact that he was not talking to accountants drew a pencil from his pocket and started explaining his method on a piece of paper. "Direct material costs add direct labour costs and manufacturing overheads applied at the agreed rate of direct labour hours plus a 175 percentage mark-up on costs help us arrive at our price."

"And, what costs form part of the manufacturing costs you just outlined?" enquired Mike. "Ah, well a great deal like the seasoning of canvas to preserve its texture and durability, engraving the artists name to the painting, the special drying to help the color set fast and the mounting of wooden frames to render the painting ready to be displayed" Scott replied. Mike and Sam exchanged a confused look. The art of accounting and the accounting for art both presented formidable challenges and seemed momentarily incomprehensible. "Could you please give me that paper, Scott?" asked Mike. He decided to seek external help.

Prof. Podlovsky: Indiana School of Art

Mike remembered his sessions with Prof. Podlovsky. An impressive artist, Prof. Pod as he was popularly known taught accounting at ISA. Pod's research interests were in designing and developing Activity Based Costing systems and designing Balanced Score Cards. His consulting experience was rich and varied. Being both an artist and professor, Prof. Pod was in a better position to understand Mike's business. Mike sought Pod's help through e-mail. Since Mike had served under Pod for his term paper, Mike was sure Pod would remember him and respond. Pod was Mike's only hope.

Mike's E-mail to Pod:

Dear Prof. Podlovsky,

It gives me great pleasure to be writing to you after long. I introduce myself as Michelangelo (Mike) of the ISA Fall Batch 2009. I still cherish the memories of your classes and my student days at ISA. Hope this e-mail finds you in good health and spirit.

I write this e-mail in my representative capacity as CEO of iRis Creations, a company that I founded after graduating from ISA. The going so far has been pretty good; however, recent circumstances have necessitated this e-mail.

I seek your help on an important pricing decision that I need to make to keep me in business.

Two questions reign uppermost in my mind and I seek your guidance in answering them:

- i) Is my current pricing policy of 175 percentage mark-up on total cost appropriate?
- ii) Is there any room for me to reduce my selling prices? How do I figure this out?

I have attached details of my business and its cost structure (exhibits 1 - 3) and look forward

to your observations.

With fond regards,
Mike
CEO, iRis Creations

Prof. Pod's Response:

Dear Mr. Mike,

It is nice to hear from you after a long time. Having carefully examined the details provided by you, I opine that the present policy of adding a 175 percentage mark-up to total costs is appropriate. This is consistent with the practice prevailing in the industry and hence needs to be continued.

However, I do recommend a re-examination of the method being pursued to allocate your manufacturing costs to products. My analysis of your manufacturing overheads reveals that you have chosen to use direct

labour hours as your primary overhead cost driver. I invite your kind attention to the fact that landscape and portrait paintings differ in the amount of labour time. While landscape painting is less labour intensive than portrait, using direct labour hours as the basis for absorbing overhead costs is inappropriate. Choice of incorrect activity driver is distorting your pricing.

I regret my inability to delve on the questions you asked. My spouse's protracted illness requires my undivided attention and due to this reason, my Chair falls vacant tomorrow. Never the less, I submit a template for your reference. The following questions would help you in your analysis:

- i. What are the broad categories (activity pools) of your manufacturing costs?
- ii. What major activities mark each category identified?
- iii. What could be the most significant cost driver for that activity?

A smart student as you were, I sincerely hope you will figure out the solution all by yourself. Wish iRis Creations and you the very best in all further endeavors.

God bless.

Prof. Podlovsky
 Chair, Accounting
 Indiana School of Art.

The Task Ahead:

Mike read the e-mail and understood the message: choice of incorrect activity driver was distorting his pricing. He forwarded the mail to Scott with this note: "Dear Scott, help me

perfect the ABC-S (Activity Based Costing System) for art. I am eager to learn this from you.

Let us meet at 9.00 A.M tomorrow. Your inputs will be critical for the future of iRis.

Assigned Questions:

- 1) As Sam, provide the basic inputs to Scott on the current prices charged by iRis.
- 2) As Scott, perform the necessary calculations to help Mike make a decision.
- 3) As Mike, what will be your response based on the workings provided by Sam and Scott?

Exhibit-I: iRis Creation's Production Sequence		
Stage-I (Pre-production)	Stage-II (Production)	Stage-III (Post-production)
Selection of primed canvas	Master painting	Seasoning of canvas
Sizing of canvas	Contrast setting	Fumed drying
Undercoat of canvas		Signage engraving
Graphite sketch of painting		Frame mounting
↓	↓	↓
DIRECT MATERIAL	DIRECT LABOR	INDIRECT COSTS (Absorbed on DLH)*

*DLH=Direct Labor Hours

	Exhibit-II: Cost Structure/Pricing	
	Landscape	Portrait
Number of paintings	34950	7500
Number of work orders	440	110
Direct material costs (\$)/unit	25	35
Direct labor (hrs.) per painting	2	8
Direct Labor Rate(\$)/per hour	5	5
Manufacturing (indirect) costs	\$364000	

Exhibit-III: Manufacturing Costs Description		
Nature of activity	Description of activity	Total Cost (\$) Absorption basis
The manufacturing costs comprise of production department costs of \$249400 and utilities (power) cost of \$ 114600. A total of 5 lac kWh will be required of which 35 % is towards heating and the rest for running machines for signage engraving. A detailed description of the costs are as follows:		
Seasoning of canvas	A set of 10 trained assistants work on waxing the canvas top reserve its dexterity and tenure. Since portraits on canvas require more seasoning 8 of the 10 assistants work on portraits.	DLH
Setting up of canvas	Seasoned canvas needs to be setup for production. A total of 150 production runs is required for landscape and 50 Production runs for portrait paintings.	DLH
Fumed drying/heating	Each completed canvas is exposed to fumes to enhance the color setting properties on canvas. The process is carried out in a special purpose chamber supervised by an assistant. The process consumes 30,000 kgs of charcoal of which 26,000 kgs are required to fume dry landscape paintings and the remaining for portraits.	DLH
Signage Engraving & Frame Mounting	The signature of the artist and the production house is engraved on the painting and a frame is mounted. This is a mechanized process that is automated. A total of 50000 machine hours are required for the same of which 90% of the hours are for landscape and the rest for portrait.	DLH

