1960

A Guide to Cost Justification: "Canons of Construction"

John E. Murray Jr.
Sometimes a seller charges different prices for goods of the same grades and quality even in the same trade area. When the sales relate to interstate commerce Robinson-Patman hangs over him. But under Section 2(a) of the Act\(^1\) "cost justification" is a valid defense. The seller attempts to show that his price differentials are no greater or less than his cost differentials. If he is successful in establishing the cost defense, the seller will escape a Federal Trade Commission cease-and-desist order or a private treble damage verdict.

There are many writings suggesting that the possibilities of success in establishing the cost defense are remote since the defense is practically "impossible,"\(^2\) or it "is available only to the wealthy, the resourceful and the tireless,"\(^3\) or it is "largely illusory."\(^4\) In one of its rare opportunities to evaluate the cost proviso, the United States Supreme Court stated:

> "We have been invited to consider in this connection some of the intricacies inherent in the attempt to show costs in a Robinson-Patman proceeding. The elusiveness of cost data, which apparently cannot be obtained from ordinary business records, is reflected in proceedings against sellers. Such proceedings make us aware of how difficult these problems are, but this record happily does not require us to examine cost problems in detail. It is sufficient to note that, whenever costs have been in issue, the Commission has not been content with accounting estimates; a study seems to be required, involving

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\(^2\) Rowe, *Price Discrimination, Competition and Confusion: Another Look at Robinson-Patman*, 60 Yale L. J. 929, 963 (1951); five years later, Mr. Rowe retreated to depicting the defense as, "... an expensive gamble at best," Rowe, *Price Differentials and Product Differentiation: The Issues Under the Robinson-Patman Act*, 66 Yale L. J. 1, 23 (1956).


\(^4\) REPORT OF THE ATTORNEY GENERAL'S NATIONAL COMMITTEE TO STUDY THE ANTITRUST LAWS, 171 (1955); *see also*, concurring opinion of Chairman Howrey in *Sylvania Electric Products, Inc.*, 51 F. T. C. 282, 290 (1954).
perhaps stop-watch studies of time spent by some personnel such as salesmen and truck drivers, numerical counts of invoices or bills and in some instances of the number of items or entries on such records, or other such quantitative measurement of the operation of a business."

Even in its rather superficial analysis of the problems of cost justification, the Court managed to pinpoint the crucial factor in the attempt to establish the defense, to wit, the difficulties involved in preparation. Implicit in the Court's concept of the difficulties of cost justification is that the preparation of the cost defense requires a rather curious mixture of law, accountancy, market analysis, statistics and, perhaps, time-and-motion study. One writer suggests that when a respondent seeks to utilize the cost defense, he must, of necessity, engage in "A trial by the ordeal of cost accountancy." The costs which may be shown by a respondent to justify price differentials are limited to those which flow from the different methods of sale and delivery or different quantities sold.

"... cost difference ... [must have] its origin in:

(1) A different method by which one order was sold, or
(2) A different method by which it was delivered, or from
(3) Savings in manufacturing, selling, and delivering resulting from a difference in quantity sold or delivered, or
(4) Any combination of these three."

Since there must be a relation between the costs to be included and the methods or quantities of sale or delivery, is this not really another way of saying that the cost defense is relegated to justifying distribution costs, or generally, "... all costs incurred after the goods have been made available for sale?" The answer is, virtually, yes. In the terminology of the accountant, we are usually dealing with those expenses which follow cost of goods sold and gross profit on the profit and loss statement. The single exception occurs when manufacturing is characterized as "special order" or "job shop" production, i. e., the order is placed before production commences perhaps necessitating the use of new dies or machine adjustments. In this situation, these might be fixed expenses which can be traced to a particular customer and tend to increase or decrease as the customer's purchases decrease or increase. The normal situation, however, is that of production for inventory, i. e.,

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8 LONGMAN & SCHIFF, PRACTICAL DISTRIBUTION COST ANALYSIS 69 (1955).
everything is produced for the same pile and orders are filled from that pile. Here, there is no manufacturing economy in filling one order as contrasted with filling another order. Hence, the cost justification defense is concerned with distribution costs except in those rare instances when "special order" or "job shop" production is the characteristic of the business charged with price discrimination.\(^9\)

If manufacturing costs were exclusively considered instead of distribution costs, the task of establishing the defense would be greatly simplified. This is because, "There is considerable literature on the subject of manufacturing cost accounting,"\(^10\) since it has been the tendency of management to place great emphasis on the economies obtainable through production cost control. Production cost accounting has developed rapidly so that, at the present time, it is a well-defined body of knowledge. In the distribution area, marketing research has also developed rapidly in recent years but "... the cost control aspect has been deemphasized."\(^11\) The market analysts have been occupied with other phases of marketing the product such as motivation analysis in order to determine what makes the consumer buy.\(^12\) Thus, the tool which the respondent must use in establishing cost justification is a rather crude instrument.

To facilitate the use of the cost defense by respondents and the administration of the defense by the Commission, the FTC has initiated the preparation of two guides in this area. The first guide was promulgated in 1941 and is, at the present time, out of print.\(^13\) The most recent "unofficial"\(^14\) effort initiated by the Commission is the Advisory Committee Report on Cost Justification to the Federal Trade Commission. The purpose of this article is to evaluate the Advisory Committee Report in order to ascertain whether or not it affords substantial assistance to a respondent who seeks to vindicate price differentials by the utilization of the cost defense.

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\(^12\) See, PACKARD, *The Hidden Persuaders* (1957).
\(^13\) CASE STUDIES IN DISTRIBUTION COST ACCOUNTING FOR MANUFACTURING AND WHOLESALING, H. R. Doc. No. 287, 77th Cong., 1st Sess. (1941); the "Case Studies" are available, however, in many libraries.
\(^14\) Neither of the two guides are an official pronouncement by the FTC on cost justification.
Purpose and Scope of Report

"The Advisory Committee will ascertain whether it is feasible for the Federal Trade Commission to develop standards of proof and procedures for cost accounting which can be adopted by the Commission as guides to business enterprises."

When the announcement of the formation of the Advisory Committee was made, prognostications of the results of the Committee's efforts ranged from a rehash of general principles to a detailed manual which would be a panacea for cost justification purposes. The average businessman was probably "... hoping that the Committee would come up with a practical formula which would enable him to make approximate judgments respecting the relations between his cost and price differences." Among lawyers and accountants whose clients were involved in cost justification matters, there were many who felt that the Advisory Committee, with its excellent staff, would produce a revealing document which would materially assist them in their endeavors and, perhaps, miraculously solve some of the issues which had little or no precedent in the recorded cases. Before the completion of the Report, the Chairman of the Advisory Committee called the "miraculous" label a fallacy:

"... the committee has not felt that it is called upon to perform miracles. Two miracles seem sometimes to be expected. One is the concoction of a practicable cost accounting system which will give a definitive Robinson-Patman answer at any time by looking at the right page in the ledger. The second is an invention whereby a cost defense may be made costless and easy. Neither miracle will come out of the committee deliberations."

The Chairman further indicated that Robinson-Patman cost accounting was, itself, a miracle: "While it is perhaps hyperbole to call a Robin-

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15 ADVISORY COMMITTEE ON COST JUSTIFICATION REPORT TO THE FEDERAL TRADE COMMISSION, 1-2 (1956); hereinafter referred to as "Report." The Report is popularly known as the "Taggart Report" in honor of the Chairman of the Advisory Committee, Professor Herbert F. Taggart.
16 Daniel, Cost Report is Held No Practical Aid in R-P Costing Matters, TRADE PRACTICE BULLETIN (1956).
17 The members of the Advisory Committee were: H. T. McAnly, Ernst & Ernst, accountants, Cleveland, Ohio; Otto F. Taylor, O. F. Taylor & Co., New York, N. Y.; Albert F. Sawyer, Sawyer & Marion, New York, N. Y. and Washington, D. C. (Mr. Sawyer was the only attorney on the Advisory Committee); Alvin R. Jennings, Lybrad, Ross Bros. & Montgomery, accountants, New York, N. Y.; C. R. Fay, accountant, Pittsburgh Plate Glass Co., Pittsburgh, Pa.; E. W. Kelley, Macy's, Kansas City, Mo.; Herbert F. Taggart (Chairman), Professor of Accounting, Univ. of Michigan, Ann Arbor, Michigan.
18 Taggart, Problems of the Cost Justification Committee, ANTITRUST LAW SYMPOSIUM, Section on Antitrust Law of the New York State Bar Association, 30 (1955).
son-Patman cost accounting system a miracle—and hence to imply impossibility—a miracle it remains for practical purposes.”

This language points up the underlying philosophy of the Advisory Committee: a detailed manual of Robinson-Patman cost accounting is impossible and, therefore, only generalized principles can be enunciated. Diametrically opposed to this philosophy is that of Mr. William Warmack who, unfortunately, was not a member of the Advisory Committee.

Mr. Warmack, whose reputation in the cost defense area places him on an equal plane with Professor Taggart, suggests that “...there is nothing mysterious or miraculous about...” Robinson-Patman cost accounting.

Another aspect of the Report to be lamented is the absence of any minority views which clearly existed. Thus, the philosophy of Chairman Taggart which permeates the Report, the absence of personnel with different views such as Mr. Warmack from the Committee and the absence of dissenting opinions which leads to broad compromises, underlie the basic approach which the Advisory Committee took in the preparation of the Report.

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19 Ibid.

20 It is possible that Mr. Warmack precluded himself from becoming a member of the Advisory Committee by suggesting to former Chairman Howrey of the FTC and subsequently to Professor Taggart (via telephone) that he would not consider becoming a member of the Committee. The question of Mr. Warmack’s motivation in this matter arose in Congressional Hearings in which a question also arose as to the propriety of Professor Taggart’s becoming a member of the Advisory Committee when cost material which was partially his work was pending before the Commission. This was the essence of Mr. Warmack’s refusal (in advance) to become a member of the Committee:

...I had cost matters up before the Commission at that very time, and have had them up before the Commission almost continuously, or off and on, at least. And, it was just my feeling, Mr. MacIntyre (counsel for the Congressional Committee) that maybe I should not go down and participate in trying to establish a measuring factor or a yardstick with which the Commission would, in turn, measure the costing material I had in before the Commission or would put in during the time that I would be serving on the Committee...

Hearings Before the Select Committee on Small Business, House of Representa-

In all fairness to Professor Taggart and the others, it should be noted that it is not uncommon for interested parties to serve on such committees and the reason for this is that, as a practical matter, if such interested people were not on the committees, some of the best talent would be wasted on matters in which they could conceivably contribute a great deal.

21 Mr. Warmack was a Commission accountant for several years; he has written many articles in the field; he has been an expert witness and cost consultant for many past respondents; he is editor and publisher of the Trade Practice Bulletin and the Trade Practice Annual, in which many articles authored by him have appeared in relation to the cost defense. His Robinson-Patman costing opinions have been continually accepted and upheld by the Commission and the courts and they have been cited as authoritative by the United States Supreme Court.

22 Warmack, Robinson-Patman Costing Not Too Difficult or Expensive, TRADE PRACTICE ANNUAL, (1956).

23 On page 2 of the Report, the statement is clear that minority views have not been presented; thus, the principles in the Report smack of broad compromises.
"The Taggart Report performed a service in urging on the Commission a flexible approach to the defense and in recommending against the adoption by the Commission of any particular cost accounting system or method of cost analysis in weighing attempted cost justifications. Having taken this position, the Taggart Committee could not have been expected to lay any but the most general guides either for the Commission or for the litigant." (Emphasis added)

Basic Interpretations of Cost Proviso

Section 2(a) of the Act permits a differential in price if the seller can show that such differentials "make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered." Part II of the Report seeks to interpret this statutory language by analyzing certain key phrases contained therein: (1) "differentials in price," (2) "due allowance," (3) "resulting from," and (4) "differences in the cost of . . . delivery."

(1) "differentials in price"

In general, the "price" of a commodity is the consideration or amount which the buyer pays, but the definition of price depends upon the intent of the parties. Thus, if one charges $1.00, f. o. b. seller's plant, or f. o. b. buyer's plant, the price is still $1.00, even though the buyer pays the freight in one case and the seller in the other. But, if one charges $1.00, delivered, to one buyer and 90c to a buyer who picks up the product, there is a price differential and the seller must justify the 10c difference. There are many practices between these extremes where the seller absorbs part, but not all, of the transportation cost. In such cases, the price is still the amount the buyer pays for goods, "including as 'goods' whatever transportation the seller may furnish." If the "price," as here defined, is different to different buyers, this difference must then be justified. "Zone pricing" involves setting prices according to geographic zones, with uniform prices within a zone, but possibly different from zone to zone.

The "price" is the amount paid after deducting discounts, allowances or rebates to which the buyer is entitled in view of the quantity or methods of his purchases. Thus, with a $10 billing on which the buyer deducted $1.00 in remitting, or pays the full $10 but receives a $1.00 rebate, the price is $9.00. Such allowances take various forms, follow various procedures and receive various names ("trade," "functional,"

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25 Report, 2.
"volume," "quantity," "cash," etc.), but in any event the "price" is still the net amount which the buyer pays. Indirect price concessions such as varying terms of sale and "service" allowances, must also be considered in determining net price.

In relation to cash discounts, the example given in the Report is clear: the price of the commodity is $10 to A and $10 to B, but if A pays within 10 days, the price to A is $9.80 since A is entitled to a discount of 2 percent. Whether or not A pays within 10 days, the price to A is still $9.80, constituting a differential of 20 cents which must be justified. The reason for this is that whether or not A avails himself of the cash discount, he is entitled to it.

In the Sylvania case, a controversy arose over cash discounts when the hearing examiner rejected the respondent's theory that prices should be compared after cash discounts were deducted. Instead, said the hearing examiner, gross prices before cash discount should be compared. While the Report does not mention the Sylvania case, it adopts the theory urged by the respondent in that proceeding. Since the issue was bypassed on appeal, quaere, may a respondent rely on the theory suggested by the Report and proceed to compare prices net of cash discount? The answer must be in the negative since the Commission staff is bound only by the conclusions of the Commission and there is no guarantee that the position it took on a matter which was left unresolved will change, the Report notwithstanding. Thus, the respondent should ascertain the Commission's position before comparing any prices. This can be done in informal negotiations with the Commission staff.

The prices to be compared in a Robinson-Patman proceeding may be the prices on individual commodities, or where different commodities are normally grouped together or sold as a "set," the prices of the group or set may be compared. If the seller markets a line of related products, the prices of all of these related products may be averaged.

In this respect, the Report is apparently acquiescing in the averaging
of prices by the respondent in the Sylvania case which was accepted by the Commission. The Commission allowed the respondent to average the prices of 600 different types of renewal radio tubes because only the average price had any competitive significance, whereas the individual tube prices when compared did not have any competitive significance. Why? The answer lies in the nature of the product sold by replacement tube distributors. Economists would characterize the demand for replacement radio tubes as inelastic, i.e., a change in price would bring a less than proportionate change in the amount of tubes taken by customers. The distributors of the replacement tubes performed a mechanical sales function since they could not "push" one type of tube rather than another type. The demand in this case was not primarily for individual items and the volume of sales did not depend upon tube price differences. While individual price differences varied widely from tube to tube, the Commission felt that there was no competitive significance in this fact since as to the types of tubes which manifested the greatest price differentials, these were in the least demand. The Commission indicated that the situation would be different where demand was primarily for individual items and not for a whole line of related products and also where the volume of sales depended on price differences and other similar competitive factors.

The Report suggests that when a seller attempts to justify average price differentials, he bears the burden of proof in showing the "reasonableness of that method of comparison." In order to ascertain whether or not the comparison is reasonable, the Report suggests that the seller should consider three criteria: (1) The degree of similarity of use, i.e., the function which the products sold in a related line perform should be similar. In the case of radio tubes, all of the tubes had a common physical function though they differed in price, shape, size and composition. (2) The extent to which different customers or customer classes do in fact purchase the items or products in the "set" or related line in similar proportions. In order for a radio tube distributor to be an efficient businessman, he must carry the entire complement of tubes. (3) The competitive significance, if any, of the lack of uniformity in the price spread on individual items. This was the principal consideration in the Sylvania case, to wit, whether price differentials which were greater on some types of tubes than on other types suggested any competitive significance.

As to these criteria, it is interesting to note that the first two were violated without any apparent ill effect on the respondent in the Thomp-
son Products case. Among the related items which were aggregated in order that their prices could be averaged were valves and tie rods which differ sharply in function so that the degree of similarity of use criterion seems to have been violated. In relation to the second criterion, the extent to which the products in a related line were bought by different customers or customer classes, the favored customers in the Thompson case (i.e., those paying the lower prices) were the original equipment manufacturers (OEMs); the nonfavored customers (i.e., those paying the higher prices) were the wholesale distributors. All of the distributor customers bought valves and tie rods; some of the OEM's, however, bought only valves; others bought only tie rods, and only some of the OEM's bought both products. In spite of the violation of two of the three criteria set out in the Report, the Commission accepted the averaging of commodity prices by the respondent. The only issue relating to "averaging" in that case concerned the attempt by the respondent to average the costs of serving all of the original equipment manufacturers.

Special problems may arise when goods which differ in minor respects but are, nevertheless, "goods of like grade and quality," are compared on the basis of price. For example, goods may be packaged individually for one customer while the same goods may be sold in bulk to another customer; or, a commodity may be painted for one customer and not painted for another. If the additional price for the added operation and/or material is specified in the sales contract or invoice, the prices to be compared are the stated prices for the basic commodity and no problem arises. But, if the prices are all-inclusive, i.e., without specification of the price of the basic commodity, it becomes necessary to compute a price for the basic commodity. For example, a furniture company sells chairs which are basically identical but which may differ, at the option of the buyer, in that the purchaser may purchase them in either a painted or unpainted condition. Buyer X buys 100 chairs at a price of $2 each, such chairs being in an unpainted condition. Buyer Y purchases 100 painted chairs at $2.50 each. If the invoice to buyer Y specified the price of the unpainted chairs (i.e., the basic commodity), no problem would arise as to which prices were comparable. If the price of the unpainted chairs as stated on the invoice to buyer Y were $2 and

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28 Thompson Products, Inc., CCH Trade Regulation Reporter (FTC Rulings, Respondents, Trade Rules), §§27,841, p. 36.908 (1959).
the additional cost of painting 50c, the comparison of prices between buyers X and Y would show no price differential since they were both paying $2 for the basic commodity. On the other hand, if the invoice to buyer Y was all-inclusive, i.e., without specification of the price of the unpainted chairs, how is the price of the basic commodity determined so as to compare prices between X and Y? The Report suggests a formula to be used in this situation:

"... compare the factory costs, either actual or standard ... and make the assumption that the same rate of gross margin applies to each dollar of cost, whether for the basic commodity or the added processing ..."\(^{80}\)

In the accountant's mind, this formula is reasonable since it is to be expected that any special finish or processing such as painting the chair, would carry its own markup. In the invoice to buyer Y, the price is stated to be $2.50 per chair without specification of the price of the unpainted chair or the price of the painting process. If it is determined that the cost of making the chair is $1.00 and the cost of painting is 25c, the $2.50 price contains markups of 100% on the basic commodity and also on the added processing. Suppose, however, that the seller decides to provide the painting service at cost, and it costs 50c to paint each chair. If the cost of making the chair is $1.00 and the cost of painting is 50c, the application of the formula in the Report will result in a 66 and 2/3rds percent markup on the price to buyer Y of $2.50. As to buyer X, however, the markup is still 100% (cost = $1.00, price = $2.00). Thus, X may allege price discrimination and there can be no cost justification defense. In this respect, the Report has been accused of allowing a possible incongruity, thereby necessitating a fuller exposition of the proposal itself.\(^{81}\) There is, however, in the language of the proposal a possible clue as to why such incongruity would not be permitted. The formula is prefaced with the phrase, "A satisfactory approach to the problem is ..." Thus, the formula is not exclusive; it merely suggests a possible approach which the Advisory Committee felt would be a satisfactory one. Yet, since the Report does not consider such an incongruity, it is probably true that "fuller exposition" is necessary.

(2) The meaning of "due allowance"

The Report considers the phrase "due allowance" as found in the statutory language to be "[a]t the heart of the cost proviso ..." The

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\(^{80}\) Report, 5.

correct interpretation of this phrase is of prime importance since it was the intent of the legislators who voted the Robinson and Patman bills into law to allow sellers to pass on to customers the benefit of economies in manufacturing and distribution. The phrase should not be construed in every case to require full and complete cost justification of a price differential. Instead, the phrase should be construed flexibly so as to require only reasonable allowance for cost differences based on sound accounting principles and sound pricing principles.

Elsewhere, Professor Taggart indicated that if the businessman can show a reasonable allowance for cost differences, this is all that he can be expected to do; in fact, this is the "careful businessman's approach" to the problem of cost justification.\textsuperscript{82}

"... even the most careful businessman makes decisions on the basis of approximate costs. He is satisfied, and rightly so, with costs computed along conventional lines and containing considerable elements of judgment. There are, of course, very sound reasons for this attitude. In the first place, business decisions are seldom if ever made on the basis of costs. In many cases matters of relationships with employees, customers, competitors and the general public outweigh costs as decision-making factors. Thus the necessity of exactitude of cost data is minimized."\textsuperscript{33} (Emphasis added)

In light of this reasoning, the Report "... approves the position taken by the Commission in applying a \textit{de minimis}\textsuperscript{34} concept to cases where price differentials are not shown to be completely cost-justified but where circumstances minimize such failure to the extent that no corrective action is deemed necessary."\textsuperscript{35}

The first "very sound reason" given by Chairman Taggart in support of his suggestion that a businessman can be satisfied with only an approximate knowledge of costs is that "business decisions are seldom if ever made on the basis of costs." \textit{Quaere:} should a business decision such as establishing quantity discount brackets be made on the basis of costs? There are, of course, sound business reasons why such a decision should not be made absent a rather detailed knowledge of costs.\textsuperscript{36} Moreover, the very fact that the seller charges different prices is enough to suggest that if the seller wishes to comply with the law, he should have a rather detailed knowledge of cost differentials.

\textsuperscript{82} Op. cit. supra, n. 18 at 32.
\textsuperscript{83} Ibid.
\textsuperscript{34} \textit{De Minimis Non Curat Lex}, the law does not take notice of trifling matters.
\textsuperscript{35} Report, 5.
\textsuperscript{36} The "business" advantage of cost analysis are the minimizing of costs and thus maximizing profits.
As to price discrimination, the standards that have been established by the business community are not identical with those of the law. "Certain it is that no legislative enactment in our recent history has been more widely disregarded by the persons to whom it applies." The Report, when read in conjunction with statements made elsewhere by the Chairman of the Advisory Committee, is suggesting that the law should become more flexible not because the law would be better if it were more flexible but rather because the standards of the business community would be more consistent with a law that would be flexible enough to conform to those standards. The fact that "business decisions are seldom made on the basis of costs" should not mean that Robinson-Patman decisions should not be made on the basis of costs.

"... the standpoint from which the cost justification for price discrimination must be judged is the over-all legislative, or public policy and not that of the producing enterprise. Here other considerations come into play."  

In its approval of the de minimis rule, the Report suggests that "... a primary test to be applied is the relation of the unjustified portion to the differential itself, not to the higher unit price." Thus, if the price of the product to A was $1.00 and the price to B was $1.50, the price differential would be 50 cents. If the price differential were justified to the extent of 40c, the Report recommends that the "primary" test to be applied is the relation of the unjustified portion of the price differential (10c) to the differential itself (50c) and not to the higher unit price ($1.50). The apparent intention of the Advisory Committee was to facilitate the application of the de minimis rule. The test suggested by the Report has not been seen in the recorded cases which have applied two other tests:

(A) In Minneapolis-Honeywell, U. S. Rubber, and the Sylvania case, the de minimis principle was applied by relating the unjustified portion of the price differential to the price of the product and not to the differential itself, as recommended by the Report.

(B) In the B. F. Goodrich proceeding, counsel for both sides
agreed that all price differentials were cost justified with the exception of one discount bracket applicable to waterproof footwear. The percentage of total waterproof footwear sales affected by this one unjustified bracket amounted to substantially less than ½ of 1 percent. From these facts, the hearing examiner concluded:

"There can be no public interest ... in pursuing an inquiry relating to a discount bracket affecting such an insignificant proportion of respondent's business from which no possible substantial injury to competitors could result." 44

This result has been called a "... substantial development and extension of the de minimis rule." 45 Here, the unjustified portion of the price differential was not compared with the differential, nor was it compared with the price of the product. The significant factor did not concern the unjustified portion of the differential at all; instead, the Commission was concerned with the effect on competition that resulted in allowing or not allowing this discount bracket to go unjustified. Even if this particular quantity discount were not justified to any degree, it would not suffice to warrant an issuance of a cease-and-desist order since the requisite effect on competition was not present. The basis for the application of the de minimis rule in any case is that a failure of cost justification is not fatal when such failure will not injure competition or competitors. In the Thompson Products case, 46 the Commission's refusal to apply the de minimis rule was accompanied by the explanation that in the particular industry being considered competition was extremely keen, margins of profit on individual items were exceedingly small, and even a 2% cash discount allowed by the respondent was very important to the respondent's distributor customers. Thus, certain unjustified differentials ranging between 3.07 percent and 6.91 percent were clearly not de minimis in character. Whether a respondent will be able to avail himself of the de minimis rule is a matter which the Commission determines being guided by the difficult concept of injury to competition, considering the unique and significant elements in the particular adjudication. Perhaps the unjustified differentials in Thompson Products would have been considered de minimis had competition in that particular industry been less keen and/or if the profit margins on individual items had been substantially greater. What is de minimis in one situation may not be de minimis in another.

44 CCH Trade Regulation Reporter, Vol. I §3506.105.
45 Op. cit. supra., n. 31 at 413.
In light of these facts, the "primary" test of the Report has been criticized on the basis that the "... de minimis principle is a diffuse one, and ... no 'primary test' should be set up." 47

A recent Commission decision extends further support to the suggestion that the principle is a diffuse concept. In Hamburg Brothers, Inc., the hearing examiner said:

"Considering the volume of respondent's business with both group I and group II customers, the price differences in favor of those customers in group I in those sales which have not been ... justified ... are so small, figured either on a percentage basis or on a total dollar basis, that they could not substantially lessen, injure, destroy or prevent competition between respondent's customers." (Emphasis added) 48

(3) The meaning of "resulting from ...."

The cost proviso permits price differentials based on cost differences "resulting from different methods or quantities" in which such goods are sold or delivered to different customers. The legislative history clearly indicates that Congress intended this "resulting from" language to be broadly interpreted. 49 There are many different quantities and methods of sale and delivery which may give rise to cost differences. These differing methods and quantities are usually ascertainable upon analysis of the seller's manufacturing and distribution system. The analysis of differing methods and quantities of sale and delivery should interpret these terms in their broadest connotation, giving full effect to all items of cost difference.

The suggestions of the Report in this section are similar to "canons of construction" which do not tell the reader a great deal. If the "resulting from" language should be broadly interpreted, and perhaps it should be, does that mean that the interpretation should be more expansive than it is at the present time? If so, how restrictive is the present interpretation of the statutory language? Absent references to recorded cases or, as a minimum, some examples of what is "broad" interpretation, it is difficult to draw any conclusions as to what the Advisory Committee intended to say. The same criticism is applicable to the "differing methods and quantities" language which terms, according to the Report, should be interpreted in their "broadest connotation." Without a fuller exposition than is given in the Report, the lawyer does not know what the Com-

49 The Report cites Congressman Utterback at 80 Cong. Rec. 9417 (1936); actually, the Report cites the page number as 9415 which is, apparently, a misprint.
mittee intends to suggest in this section.

(4) Delivery cost differences

The Report suggests that when differences can be shown in costs of delivery, such cost differentials should be permitted to be included in the summation of cost savings even though no differences in methods or quantities of sale and delivery exist. For example, if the distance in delivery is greater to some customers than to others with greater expenditures for delivery for the more distant customers, the cost differentials should be permitted to be shown in justification of price differentials.

Accounting Proof and Procedures

Cost accounting is not and can never become an exact science because of the inherent element of judgment which must be exercised by the cost analyst. A cost study requires judgment and opinion and any rigid approach to cost analysis would require refinements which would make the cost analysis inordinately expensive. Therefore, the Report recommends that the FTC take a broad approach in its evaluation of cost studies; such an approach is indispensable if the equitable solution of problems arising under the cost proviso is to be attained.

It is impossible to determine whether the Advisory Committee is recommending that the Commission take a broader approach to cost study evaluation than it has taken in the past as evidenced by the recorded cases, or whether the Commission’s approach has been broad enough in some cases or rigid in others. The Committee suggests that a more rigid approach (more rigid than some kind of broad approach) would make cost analysis inordinately expensive. According to William Warmack, the Commission’s present approach in evaluating cost studies does not require the studies to be refined to the extent that they become inordinately expensive; instead, Mr. Warmack would suggest that the expenditure necessary for Robinson-Patman costing should not exceed that of a salary of a good clerk. According to Mr. Warmack, the “fabulous amounts” which some respondents have paid to have cost information developed has been due to the fact that these respondents “took the law lightly, disregarded it altogether, or, at least, never went to the trouble of determining with reasonable certainty that their prices were or were not cost-justified.”

80 Report, 6.
81 Warmack, A Realistic Approach to Robinson-Patman Costing, TRADE PRACTICE ANNUAL, 11 (1954); reprinted in 100 Cong. Rec., A5452.
The Report proceeds to suggest some general principles of proof to serve as guides in the preparation and consideration of cost studies in relation to general principles of proof of an accounting nature. The Advisory Committee points up the difficulties of presenting a study based on anticipated costs. While industrial practice bases decisions on anticipated costs, the Act requires cost studies to be predicated upon actual or historical costs. Thus, the Report recommends that studies which are based on anticipated costs should be of some value if the seller is able to show that the actual cost variations resulted from operating conditions beyond the control of the seller or from changes which the seller could not reasonably anticipate. While this suggestion seems sound, the only way in which to ascertain its application is through a change in the statute.

A second general principle of proof found in the Report relates to cost studies which are made in good faith and in accordance with acceptable accounting doctrines. Such studies should, according to the Report, be given "great weight." This apparently intends to suggest that when a respondent relies upon certain accounting principles, these principles should have an evidentiary value superior to an adverse theory of accounting unless a preponderance of the evidence supports the contention that the respondent's accounting principles are not sound. Thus, the adverse theory of accounting should not be sufficient to overthrow the respondent's method even though the adverse theory would produce narrower cost differences. While the language of the Report in expressing this principle has been termed "contradictory," it would seem to be reasonably clear.

As to the extent of cost surveys, the Report states, "The preparation of unnecessarily exhaustive, time-consuming and expensive cost surveys should be avoided." This is obviously a sound suggestion but it omits the most important element, to wit, how are such exhaustive, time-consuming and expensive studies to be avoided? Mr. Warmack's suggestion affords the best advice: In order to preclude the unnecessary expenditure of "fabulous amounts" in order to have cost information developed subsequent to the issuance of a complaint, compile the data previous to the issuance of the complaint. This can be done, according to

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52 REPORT 7.
53 SCHNEIDERMAN, supra, n. 31 at pp. 406-407.
54 REPORT 7-8.
Mr. Warmack, "for the most part, by the company's own personnel at relatively little extra expense." Suppose, however, that no data has been compiled and the complaint has been issued; what is the best procedure to follow? Professor Taggart, in a subsequent writing, offers some general precepts:

"... in no case should the problem of cost justification be turned over to the 'second team.' This has been done occasionally, with disastrous consequences. Cost justification is a problem sufficiently complex to require the best brains any enterprise can afford. Some of the questions can be answered only by top company officials, who, however, should supply no answers until they are sure they perceive the implications. The job is not one for accountants alone. Highly placed operating personnel must actively take a hand in the proceedings. The lawyer may have to defend the study in Commission proceedings or in court, so he should know what is in it, how it has been prepared and why certain techniques were chosen rather than others. The qualified lawyer can also be of great assistance in planning a study, in determining its scope, and in directing its method of presentation."

The Report recommends the continued use of the classification of customers, orders, commodities and transactions. "What this means is that it is not necessary to cost-justify each sale transaction or sales to each individual customer." If no customer could be treated as a member of a class or group, cost studies would be refined to the extent of ascertaining the cost of making each individual sale. Such a procedure would not be practicable. The classification should be logical and reflect actual differences in the manner or cost of dealing. Care should be taken that all members of the class are enough alike to make the averaging of their costs a sound procedure.

The difficulties in the recommendations of the Report in this section are manifested in the approval of certain classifications of customers in the American Can Company cases by the Chairman of the Advisory

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55 Warmack, supra, n. 51.
56 Taggart, Cost Justification 542 (1959).
57 Report, 8.
58 Bruce's Juices, Inc. v. American Can Co., 87 F. Supp. 985 (S. D. Fla. 1949); aff'd, American Can Co. v. Bruce's Juices, Inc., 187 F. 2d 919 (5th Cir. 1951); petition for rehearing denied, American Can Co. v. Bruce's Juices, Inc., 190 F. 2d 73 (5th Cir. 1951); at this time, appellee's counsel were awarded an additional $5000. Russellville Canning Co. v. American Can Co., 87 F. Supp. 484 (W. D. Ark. 1949); rev'd, American Can Co. v. Russellville Canning Co., 191 F. 2d 38 (8th Cir. 1951). It is interesting to note that, "... the American Can Co. after winning its case in the eighth circuit, promptly settled with the Russellville Canning and paid it $150,000. And that is what kept the case out of Supreme Court." Hearings Before the Select Committee on Small Business, House of Representatives, 84th Cong. 1st Sess. Part II, p. 899 (1955). But see, Whitney, Antitrust Policies, Vol. II, 215 (1958).
Committee, Professor Taggart. The two plaintiffs in the private treble damage actions, *Russellville* and *Bruce's Juices*, were included by the defendant American Can Co. in the “no discount” classification. Yet, sales to Russellville ranged to volumes more than 10 times greater than the average sales to customers in that classification and more than 25 times greater than the sales to half of the customers in the “no discount” classification. Sales to Bruce's Juices ranged to volumes more than 20 times greater than the average and more than 50 times greater than the sales to half of the “no discount” customers. *Quaere:* were Russellville and Bruce's Juices *enough alike* the other customers in the “no discount” class to make the averaging of their costs a sound procedure? The Report does not give an answer to this problem even though the chairman of the Advisory Committee testified in the Russellville case to the effect that he approved the defendant's cost accounting system.  

Professor Taggart appraises the Can cases as follows: “If the Russellville and Bruce’s Juices decisions were to prevail, cost justification would become a nullity through sheer weight of the enormous burden of proof, customer by customer, and transaction by transaction.”

Thus, the Chairman would suggest that whenever you cannot classify customers as did American Can, cost justification becomes a nullity. Yet, American Can's customer classification would seem to be in square opposition to the rule stated in the Report that the members of a customer classification must be enough alike to make the averaging of their costs a sound procedure. Perhaps the majority of the Advisory Committee did not approve American Can's customer classification; it is certain, however, that the Chairman approved such classification. Absent a reference to American Can and other cases involving customer classification, the Report does not suggest what enough alike means. Instead, the reader is given a broad “canon of construction” which can mean a number of different things. The language manifests ambiguity when it is not related to concrete situations.

The Report recommends the use of sampling techniques in order to expedite the cost analysis. The type of sample recommended for Robinson-Patman purposes is the judgmental sample rather than the

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59 191 F. 2d 38, 52. (C.A. 8th, 1951).
random or statistical sample. In using the former, the individual making the sample exercises judgment as to which items or members of a homogenous group will be used to represent all of the items or members of the group. In this case, "the competence of the judgment must be established." The random sample occurs when no judgment or opinion is exercised by the individual making the sample in choosing representative items or members of a group. Instead, the choice is dictated by pure chance. The random sample should be used where feasible because of its demonstrable lack of bias.

The reader of the Report is not given the solid basis for understanding precisely what the Report recommends which could have been given by the use of three examples of the Commission's treatment of sampling in the recorded cases. In the Niehoff case, 17 sales orders were not representative of 10,008 orders. In the Morton Salt case, the Commission criticized the use of the respondent's Port Huron plant as a representative shipping point. On the other hand, U. S. Rubber's selection of three branch sales offices as representative of all branch sales offices was acceptable. Thus, in this section of the Report, once again there is no objective correlative on which the Report's recommendations can be based.

When the Report suggests that random samples should be used where feasible, it does not suggest any hypothetical situations wherein such sampling techniques may be feasible. Since the recorded cases do not demonstrate the use of random (or "pure chance") samples, the reader is left with a suggestion that requires fuller exposition.

The Report takes the position that "uniform methods and procedures for Robinson-Patman accounting are precluded" because of the infinite variations of internal organization, methods of doing business, availability of accounting and statistical data and other important factors. Any attempt to lay down detailed procedures for all business enterprises or otherwise to "strait-jacket" cost justification would be self-defeating.

This section of the Report points up a glaring difference between the Taggart school and the Warmack school. Mr. Warmack would

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63 The U. S. Rubber Co., 46 F. T. C. 998 (1950). It is interesting to note that the respondent first selected only one store, the Pittsburgh branch, as representative of all branch stores; after a conference with Commission accountants, however, the sample chosen was three stores, Pittsburgh, Buffalo and St. Louis.
answer the contention that "it is impractical to express highly definitive standards of proof" in the cost justification area by suggesting that, "We have never risen to the challenge presented by the due allowance proviso." Mr. Warmack and others have embarked upon a Robinson-Patman cost accounting study which "... will provide bases for definitely establishing standards of proof and procedures for Robinson-Patman costing which can effectively and successfully be applied ... with relatively little additional effort and expense." While the lawyer is not competent to make an absolute choice between the Taggart and Warmack theories, he is naturally sympathetic to the latter's suggestions since the lawyer's experience and training have shown him many instances of extremely complicated situations which are regulated by detailed codes and statutes. Mr. Warmack is not suggesting that a cost justification problem can be solved by "turning to the right page in the ledger." He is suggesting, however, that standards of proof can be developed which will be adequate for most situations in the cost defense area; he is suggesting that procedures for Robinson-Patman costing can be developed to cover most situations. The unique situation will always necessitate a special adjudication, but this is not unfamiliar ground to the lawyer. It is extremely difficult for the lawyer to believe that it is impossible to create any uniform standards for cost justification. He cannot accept the contention that proof for cost justification is doomed to a haphazard existence or that sellers cannot know when they are obeying the law, and when they are not. By and large, the lawyer's tendency is to agree with Mr. Warmack: a detailed code for cost justification can be written; it just hasn't been written.

In relation to Robinson-Patman accounting, the Report indicates that good business management does not demand the extent of detail or the continuity of records needed for instantaneous solution of the problems presented under the Act. In the event of an FTC investigation, a seller who decides to use the cost defense will always need special cost studies. Yet, a "well-designed system of expense classification suitable for cost control" can provide adequate information for business purposes and simultaneously such a system can provide the raw material necessary for special cost studies.

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64 Warmack, Standards of Proof Re R-P Costing Procedures Are to be Established, TRADE PRACTICE BULL. 2 (Nov. 1957).
65 Ibid at 7.
In this respect, the Report seems to indicate that a seller should have a cost analysis system which will allow the seller to feel secure in granting discounts, etc. The crucial question, however, remains unanswered, to wit, how detailed must such a knowledge of costs be? While it would not have been possible to answer every unique problem, the Report could have included several comprehensive examples to implement its suggestion. Absent such examples, the reader is left with another broad criterion which affords little practical assistance.

When the Report talks about methods of cost analysis, it recognizes two basic problems: (1) What can be done, on a day-to-day basis, to indicate whether price differentials are greater than, or no greater than cost differentials? (2) In the event of an FTC investigation, what additional steps will be necessitated to establish the cost defense and how much more time, effort and money will necessarily be spent? The Report answers these questions in rather cavalier fashion: since each company is different in terms of internal organization, degree of integration, variety of products, complexity of trade channels, methods of sale and delivery, range of size and functional status of customers, competitive practices, and many other features of business operation, each business must determine for itself how far it must go toward providing current data and how much must be left for special studies.

In its discussion of direct and indirect costs, the Report does little more than point up the problems. When costs are incurred separately for any one product, one customer, or one group of customers, these are direct costs which are easily assigned to the product, customer or customer group for which they were incurred. For example, a manufacturer sells two products, X and Y; the seller advertises only product X, therefore, all advertising expense is assigned to product X. When costs are jointly incurred, i.e., when they are incurred for two or more products, customers, or customer groups, these are indirect costs which must be allocated before total costs for any given category can be ascertained. A simple example, not found in the Report, would make this clearer: seller X sells products A and B; from his ordinary books of account he knows that he has spent $10,000 in advertising both products; he has spent $5000 in delivering both products; his salesmen sell both products and selling expenses amounted to $30,000. All of these costs were incurred jointly, i.e., they were incurred in the sale of both products.

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66 Report, 12.
These costs are not readily assignable to products, customers or customer groups. The best way of ascertaining that each product, customer, or group of customers bears its fair share of these indirect or joint costs is to use functional cost groups and allocate the costs in such groups among products and among customers.\(^6\) Except for certain "purely illustrative" examples contained in the appendix to the Report, the effort of the Advisory Committee does not give the reader any guidance as to the very difficult problems concerned with choosing acceptable bases of allocation\(^8\) so that the indirect costs can be allocated in such a manner that they will be acceptable to the Commission in an FTC proceeding or to a court in a private treble damage action.

Part IV of the Report contains recommendations for certain organizational and procedural changes by the Commission in its administration of the cost proviso.\(^9\) While some of the suggestions seem sound,\(^7\) they

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\(^6\) Costs are placed into functional cost groups by classifying costs according to their purpose and not according to their nature, as they are when recorded in the ordinary books of account. Thus, the question is asked, for what purpose or function was a particular cost incurred. Only in this way is it possible to allocate costs to products, customers and/or customer groups to ascertain that each product, customer or customer group bears its fair share of the cost incurred to perform each function.

\(^8\) In order to allocate costs to products, customers and customer groups, an appropriate basis of allocation must be chosen. For example, a firm sells two products, X and Y; the cost incurred to perform the warehousing function for both products is $5000. In order to ascertain how much of that $5000 is allocable to product X, a suitable basis of allocation might be the space factor, i.e., the space occupied by product X. If it is determined that product X occupied 40% of the warehousing space, $2000 of the total $5000 is attributable to product X. With each functional cost, (e.g., warehousing, selling, transportation, etc.,) the cost analyst is interested in the portion of the total costs (incurred for the performance of each function) attributable to product X because the Commission has alleged price discrimination in sales of product X. After ascertaining the costs of performing each function for product X, it then becomes necessary to spread these costs over the various customers or customer groups. It then becomes possible to compare the costs of selling product X to the various customers or classifications of customers to determine whether the cost differentials manifested between each customer or customer group are equal to, greater than, or less than price differentials between them. If the price differentials are greater than the cost differentials, the attempt to use the cost defense has failed. Thus, bases of allocation must be chosen to spread total functional costs over products, and they must be chosen to spread the functional costs for product X over customers or groups of customers. It is possible that some of the bases chosen for allocation to products will be appropriate to allocate costs to customers or customer groups.

\(^9\) The Report recommends that an Accounting Adviser post be created. Such accounting adviser would assist the Commission on accounting matters arising informally under the Act; he would assist in the preparation of continuing accounting opinions and would participate in adversary proceedings subject to call as an expert witness by the hearing examiner, on his own motion, or on the motion of either party. The hearing examiner, of course, would not be bound by the testimony of the adviser. Another sound suggestion in the Report relates to the establishment of detailed pre-trial techniques to eliminate surprise and tactical advantages and to frame the issues more precisely.
are obviously oversanguine in that they do not take account of the fact that the FTC is, at the present time, a fund-starved agency and few of the suggestions in the Report are financially feasible.

Evaluation

Up to the present time, the Report has not been officially accepted by the Commission, and there are no present indications that it will ever be accepted as an official pronouncement of the principles of cost justification. There has also been a dearth of unofficial comment on the Report. From the available material, which is admittedly sketchy, and also from answers to certain questionnaires submitted to past respondents by the author, the following evaluations are presented:

Businessmen
What degree of assistance does the Report afford the business community?

"We are familiar with the 'Taggart Report' but believe it is so generalized as to be of little assistance or practical value, although it sets up some excellent common-sense rules of reason, refers approvingly to the aggregating of costs, and in general favors the good faith approach to cost studies."\(^7\)

"The report of the Advisory Committee is useful as a general frame of reference, but does not have any definitive answers to particular problems."\(^7\)

"I am afraid that the Taggart Report would be of little or no value in gathering material for presenting a cost justification defense, other than to serve as a check-list of possible approaches."\(^7\)

There are, of course, those who have become so convinced of the impossibility of cost justification that they "... did not even bother to read the 'Taggart Report.'"\(^7\) These comments emanate from businessmen or their counsel, each of whom has been involved in at least one cost justification proceeding. They are, therefore, cognizant of the problems of the cost defense and could be expected to appraise the Report in the light of their cost justification experience.

Lawyers
The only thorough law review article which appraises the Report does so in the following manner:

"The Advisory Committee with its excellent personnel has made a contribu-

\(^7\) Letter from Lester A. Hamburg, President of Hamburg Bros., Inc., (a recent respondent in FTC proceeding involving cost justification), Dec. 8, 1958.

\(^7\) Letter from John R. Henry, General Counsel, American Can Co., January 8, 1959.


A short but nevertheless penetrating analysis of the Report suggests that it

"... is a statement of broad proposals which would require clarifying illustrations and citations to enable the average reader to understand it. ... In no sense does the report come up to ... expectations or to the stated purposes for which the Committee was created."\(^7\)

**Accountants**

Mr. William Warmack suggests:

"Wide generalizations such as those included in the report may have proved helpful in [the] early days, but there is no great need for them at the present time. They gave way long ago to specific and authoritative information on R-P costing requirements based on actual experience and case decisions. And there is now a wealth of such information built up over the past twenty years."\(^7\)

**Conclusion**

The principles stated in the Advisory Committee Report are analagous to broad "canons of construction." When applied to concrete situations, their vagueness and ambiguity detract substantially from their value.

In mitigation of this indictment, it must be stated that the members of the Advisory Committee performed this endeavor without compensation except that which came as reimbursement for traveling expenses, etc. The fact that their normal activity prolonged the preparation of the Report is evidenced by the time taken in preparation, some twenty-seven months.

By and large, what is to be lamented most is the over-summarization of material which the members of the Committee developed.\(^7\) Perhaps if more of the detailed material were included in the Report, many of the criticisms of generality would be rebutted.

As the Report now stands, it must be characterized as a failure in relation to any of the stated purposes found therein. There is nothing in the first four years of its early life to rebut this appraisal.

\(^7\) Op. cit. supra, n. 31 at 424.
\(^7\) Op. cit. supra, n. 16.
\(^7\) Warmack, Facts Not Theories Needed to Meet R-P Costing Requirements, TRADE PRACTICE BULL., 1956.
\(^7\) The Report itself states that it is a summary of material developed by the members of the Advisory Committee.