Do you know a different formula for contribution?

On a situation of demand exceeding the capacity to produce, companies would think of building up new capacity. The decision of buying additional machinery/building new factory is that of long term affecting series of cash flow of many years of the enterprise. But to tide over the crisis of demand exceeding production, before an additional capacity is built (for short term), firm will think of buying some of the components rather than manufacturing of its own. Capacity released in the process can be used for producing additional units of other components. This will end up with greater number of other components manufactured. Bought components and increased production of other components will enable the firm to meet higher levels of demand without increase in capacity. In short, the firm is forced to buy a few components instead of manufacturing entirely.

Which of the components to be bought ?

It is generally understandable that buying components would be costlier than manufacturing. Firm would incur higher cost of buying rather than manufacturing it. Savings in cost by manufacturing is equal to higher cost of buying. So a comparison is made between buying price of the component and the variable cost of manufacturing it. Whichever component is giving higher savings in the capacity released would be chosen for manufacturing. Such saving in manufacturing can be compared with contribution of a finished product. Components manufactured would not be sold directly as components but sold as finished product (after assembly). Hence selling price for the components would be non-existent. An equal factor is used to arrive at savings in manufacturing is the purchase price of the components.

Contribution for the component = Purchase price – Variable cost of manufacturing.