

# Chapter 7: Project Cost Management

Information Technology Project Management, Ninth Edition

Note: See the text itself for full citations

# Learning Objectives (1 of 2)

- Develop a justification for project cost management and its importance in achieving project success
- Explain basic project cost management principles, concepts, and terms
- Describe the process of planning cost management
- Discuss different types of cost estimates and methods for preparing them
- Using an example of an information technology (IT) project, list and describe the processes of determining a budget and preparing a cost estimate

## Learning Objectives (2 of 2)

- Justify the use of earned value management and project portfolio management to assist in cost control
- Describe how project management software can assist in project cost management
- Discuss considerations for agile/adaptive environments

# The Importance of Project Cost Management

- IT projects have a poor track record for meeting budget goals
  - Cost overrun is the additional percentage or dollar amount by which actual costs exceed estimates
  - A 2011 *Harvard Business Review* study reported an average cost overrun of 27 percent
    - Most important finding was the discovery of a large number of gigantic overages or “black swans”; a high-impact event that is rare and unpredictable, but not improbable in retrospect

# What Went Wrong?

- The United Kingdom's National Health Service IT modernization program was called the greatest IT disaster in history with an estimated \$26 billion overrun
  - Program had problems due to incompatible systems, resistance from physicians, and arguments among contractors about who's responsible for what
  - Scrapped in 2011

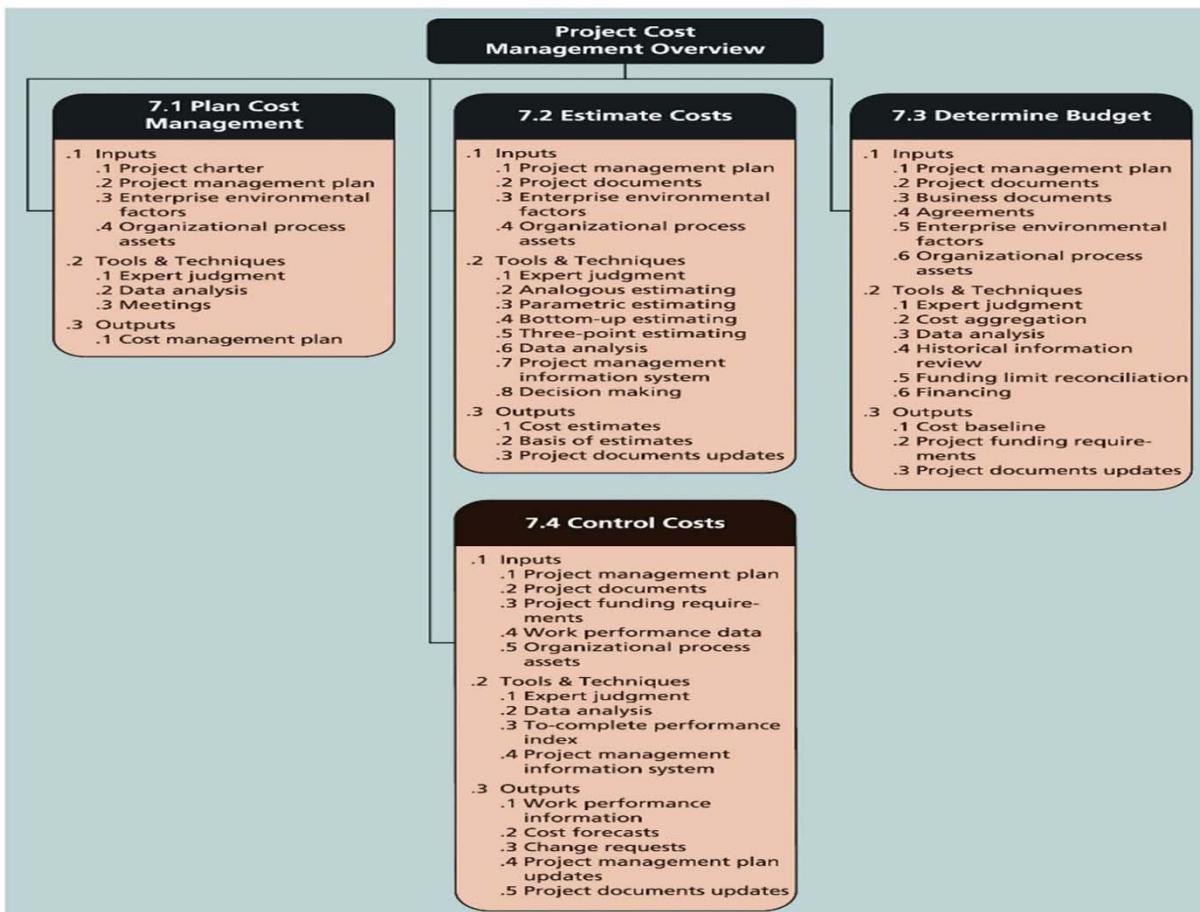
# What is Cost?

- Cost is a resource sacrificed or foregone to achieve a specific objective or something given up in exchange
  - Usually measured in monetary units like dollars that must be paid to acquire goods and services

# What is Project Cost Management? (1 of 2)

- Project cost management includes the processes required to ensure that the project is completed within an approved budget
  - Planning cost management: determining the policies, procedures, and documentation that will be used for planning, executing, and controlling project cost
  - Estimating costs: developing an approximation or estimate of the costs of the resources needed to complete a project
  - Determining the budget: allocating the overall cost estimate to individual work items to establish a baseline for measuring performance
  - Controlling costs: controlling changes to the project budget

# What is Project Cost Management? (2 of 2)



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**FIGURE 7-1** Project cost management overview

# Basic Principles of Cost Management (1 of 3)

- Most members of an executive board better understand and are more interested in financial terms than IT terms; they need to be able to present and discuss project information in both
  - Profits: revenues minus expenditures
  - Profit margin: ratio of profits to revenues
  - Life cycle costing: considers total cost of ownership, or development plus support costs, for a project
  - Cash flow analysis: determines estimated annual costs and benefits for a project and resulting annual cash flow

## Media Snapshot

- You cannot measure ROI unless you have a benefits measurement process in place
- 2015 report by PMI findings
  - Many organizations do not have a benefits measurement process
  - 20 percent of organizations report having a high level of benefits realization maturity
  - 39 percent of high-performing organizations report high benefits realization maturity compared to nine percent of low performers

## What Went Right?

- Investing in green IT and other initiatives has helped both the environment and companies' bottom lines
  - Michael Dell, CEO of Dell, reached his goal to make his company "carbon neutral" in 2008
  - As of March 2012, Dell had helped its customers save almost \$7 billion in energy costs
  - In 2014 Dell reported being on track toward reaching their goal of recovering two billion pounds of used electronics by 2020

# Basic Principles of Cost Management (2 of 3)

- Types of costs and benefits

- Tangible costs or benefits are those costs or benefits that an organization can easily measure in dollars
- Intangible costs or benefits are costs or benefits that are difficult to measure in monetary terms
- Direct costs are costs that can be directly related to producing the products and services of the project
- Indirect costs are costs that are not directly related to the products or services of the project, but are indirectly related to performing the project
- Sunk cost is money that has been spent in the past; when deciding what projects to invest in or continue, you should not include sunk costs

# Basic Principles of Cost Management (3 of 3)

- Additional concepts
  - Learning curve theory states that when many items are produced repetitively, the unit cost of those items decreases in a regular pattern as more units are produced
  - Reserves are dollars included in a cost estimate to mitigate cost risk by allowing for future situations that are difficult to predict
    - Contingency reserves allow for future situations that may be partially planned for (sometimes called known unknowns) and are included in the project cost baseline
    - Management reserves allow for future situations that are unpredictable (sometimes called unknown unknowns)

# Advice for Young Professionals

- If you have never done so, take a class or do self-study in accounting, financial statements, or financial management
  - There are many online resources and short books available on the topics of finance for the non-financial manager, how to use financial statements, or similar content
  - Financial specialists are often willing to help less-experienced people better understand the key terminology of the financial field

# Planning Cost Management

- The first step in project cost management is planning how the costs will be managed throughout the life of the project
  - The project team uses expert judgment, analytical techniques, and meetings to develop the cost management plan
- Cost management plan includes:
  - Level of accuracy
  - Units of measure
  - Organizational procedure links
  - Control thresholds
  - Rules of performance measurement
  - Reporting formats
  - Process descriptions

# Estimating Costs (1 of 4)

- Project managers must take cost estimates seriously if they want to complete projects within budget constraints
  - Types of cost estimates
  - Tools and techniques for estimating costs
  - Typical problems associated with IT cost estimates

## Estimating Costs (2 of 4)

Type of Estimate	When Done	Why Done	Typical Range
Rough order of magnitude (ROM)	Very early in the project life cycle, often 3–5 years before project completion	Provides estimate of cost for selection decisions	-50% to + 100%
Budgetary	Early, 1–2 years out	Puts dollars in the budget plans	-10% to +25%
Definitive	Later in the project, less than 1 year out	Puts dollars in the budget plans	-5% to +10%

Table 7-1 Types of cost estimates

## Estimating Costs (3 of 4)

- The number and type of cost estimates vary by application area
  - The Association for the Advancement of Cost Engineering International identifies five types of cost estimates for construction projects
    - Order of magnitude, conceptual, preliminary, definitive, and control
  - Estimates are usually done at various stages of a project
    - Should become more accurate as time progresses
  - It is important to provide supporting details for estimates and updates to project documents
  - A large percentage of total project costs are often labor costs

## Estimating Costs (4 of 4)

Department	Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Information systems	24	31	35	13	13	116
Marketing systems	3	3	3	3	3	15
Reservations	12	29	33	9	7	90
Contractors	2	3	1	0	0	6
Totals	41	66	72	25	23	227

Table 7-2 Maximum FTE by department by year

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# Cost Estimation Tools and Techniques

- Analogous or top-down estimates
  - Use the actual cost of a previous, similar project as the basis for estimating the cost of the current project
- Bottom-up estimates
  - Involve estimating individual work items or activities and summing them to get a project total
- Three-point estimates
  - Involve estimating the most likely, optimistic, and pessimistic costs for items
- Parametric estimating
  - Uses project characteristics (parameters) in a mathematical model to estimate project costs

# Typical Problems with IT Cost Estimates

- Reasons for inaccuracies
  - Estimates are done too quickly
  - People lack estimating experience
  - Human beings are biased toward underestimation
  - Management desires accuracy

# How to Develop a Cost Estimate and Basis of Estimates (1 of 3)

- See the text for a detailed example of creating a cost estimate for the Surveyor Pro project described in the opening case
  - Before creating an estimate gather as much information as possible about the project, ask how the organization plans to use the cost estimate, and clarify the ground rules and assumptions

# How to Develop a Cost Estimate and Basis of Estimates (2 of 3)

Surveyor Pro Project Cost Estimate Created October 5					
	# Units/Hrs.	Cost/Unit/Hr.	Subtotals	WBS Level 2 Totals	% of Total
<b>WBS Items</b>					
<b>1. Project Management</b>				<b>\$306,300</b>	<b>20%</b>
Project manager	960	\$100	\$96,000		
Project team members	1,920	\$75	\$144,000		
Contractors (10% of software development and testing)			\$66,300		
<b>2. Hardware</b>				<b>\$76,000</b>	<b>5%</b>
2.1 Handheld devices	100	\$600	\$60,000		
2.2 Servers	4	\$4,000	\$16,000		
<b>3. Software</b>				<b>\$614,000</b>	<b>40%</b>
3.1 Licensed software	100	\$200	\$20,000		
3.2 Software development*			\$594,000		
<b>4. Testing (10% of total hardware and software costs)</b>			\$69,000	<b>\$69,000</b>	<b>5%</b>
<b>5. Training and Support</b>				<b>\$202,400</b>	<b>13%</b>
Trainee cost	100	\$500	\$50,000		
Travel cost	12	\$700	\$8,400		
Project team members	1,920	\$75	\$144,000		
Subtotal			\$1,267,700		
<b>6. Reserves (20% of total estimate)</b>			\$253,540	<b>\$253,540</b>	<b>17%</b>
<b>Total project cost estimate</b>				<b>\$1,521,240</b>	

\*See software development estimate.

**FIGURE 7-2** Surveyor Pro project cost estimate

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# How to Develop a Cost Estimate and Basis of Estimates (3 of 3)

Surveyor Pro Software Development Estimate Created October 5				
1. Labor Estimate	# Units/Hrs.	Cost/Unit/Hr.	Subtotals	Calculations
Contractor labor estimate	3,000	\$150	\$450,000	$3,000 * 150$
Project team member estimate	1,920	\$75	\$144,000	$1,920 * 75$
<b>Total labor estimate</b>			<b>\$594,000</b>	Sum above two values
2. Function point estimate	Quantity	Conversion Factor	Function Points	Calculations
External inputs	10	4	40	$10 * 4$
External interface files	3	7	21	$3 * 7$
External outputs	4	5	20	$4 * 5$
External queries	6	4	24	$6 * 4$
Logical internal tables	7	10	70	$7 * 10$
<b>Total function points</b>			<b>175</b>	Sum above function point values
Java 2 language equivalency value			46	Assumed value from reference
Source lines of code (SLOC) estimate			8,050	$175 * 46$
Productivity $\times$ KSLOC $^{\wedge}$ Penalty (in months)			29.28	$3.13 * 8.05^{\wedge}1.072$ (see reference)
Total labor hours (27 hours/function point)*			4,725	$27 * 175$
Cost/labor hour (\$120/hour)			\$120	Assumed value from budget expert
<b>Total function point estimate</b>			<b>\$567,000</b>	$4,725 * 120$

\* Based on historical data

**FIGURE 7-3** Surveyor pro software development estimate

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# Best Practice

- Alvin Alexander wrote a book called *Cost Estimating in an Agile Development Environment* in 2015
  - Function points are a means of measuring software size in terms that are meaningful to end users
  - User stories are a common way to describe requirements in a simple, concise way
  - Developers can analyze user stories to estimate the number of internal logical files (ILFs)—a group of logically related data that resides entirely within the application boundary and is maintained through external inputs

# Determining the Budget (1 of 2)

- Budgeting involves allocating the project cost estimate to individual work items over time
  - Material resources or work items are based on the activities in the WBS for the project
- Important goal is to produce a cost baseline
  - Time-phased budget that project managers use to measure and monitor cost performance

## Determining the Budget (2 of 2)

WBS Items	Months												Totals
	1	2	3	4	5	6	7	8	9	10	11	12	
1. Project Management													
1.1 Project manager	8,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000	8,000	96,000
1.2 Project team members	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	12,000	144,000
1.3 Contractors		6,027	6,027	6,027	6,027	6,027	6,027	6,027	6,027	6,027	6,027	6,027	66,300
2. Hardware													
2.1 Handheld devices				30,000	30,000								60,000
2.2 Servers					8,000	8,000							16,000
3. Software													
3.1 Licensed software				10,000	10,000								20,000
3.2 Software development		60,000	60,000	80,000	127,000	127,000	90,000	50,000					594,000
4. Testing			6,000	8,000	12,000	15,000	15,000	13,000					69,000
5. Training and Support													
5.1 Trainee cost									50,000				50,000
5.2 Travel cost									8,400				8,400
5.3 Project team members							24,000	24,000	24,000	24,000	24,000	24,000	144,000
6. Reserves				10,000	10,000	30,000	30,000	60,000	40,000	40,000	30,000	3,540	253,540
Totals	20,000	86,027	92,027	172,027	223,027	198,027	185,027	173,027	148,427	90,027	80,027	53,567	1,521,240

\*See the lecture slides for this chapter on the Instructor website for a larger view of this and other figures in this chapter. Numbers are rounded, so some totals appear to be off.

**FIGURE 7-4** Surveyor Pro project cost baseline

# Controlling Costs

- Activities involved in controlling project costs
  - Monitoring cost performance
  - Ensuring that only appropriate project changes are included in a revised cost baseline
  - Informing project stakeholders of authorized changes to the project that will affect costs
- Several tools and techniques assist in project cost control
  - Expert judgment, data analysis, project management information systems, and the to-complete performance index

# Earned Value Management (EVM) (1 of 5)

- Project performance measurement technique that integrates scope, time, and cost data
  - Given a baseline (original plan plus approved changes), you can determine how well the project is meeting scope, time, and cost goals
- Earned value management involves calculating three values for each activity or summary activity from a project's WBS
  - Planned value
  - Actual cost
  - Earned value

## Earned Value Management (EVM) (2 of 5)

Activity	Week 1
Earned value (EV)	5,000
Planned value (PV)	10,000
Actual cost (AC)	15,000
Cost variance (CV)	-10,000
Schedule variance (SV)	-5,000
Cost performance index (CPI)	33%
Schedule performance index (SPI)	50%

Table 7-3 Earned value calculations for one activity after week 1

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## Earned Value Management (EVM) (3 of 5)

Term	Formula
Earned value (EV)	$EV = PV \text{ of all completed work}$
Cost variance (CV)	$CV = EV - AC$
Schedule variance (SV)	$SV = EV - PV$
Cost performance index (CPI)	$CPI = EV/AC$
Schedule performance index (SPI)	$SPI = EV/PV$
Estimate at completion (EAC)	$EAC = BAC/CPI$
Estimated to Complete (ETC)	$ETC = EAC - AC$

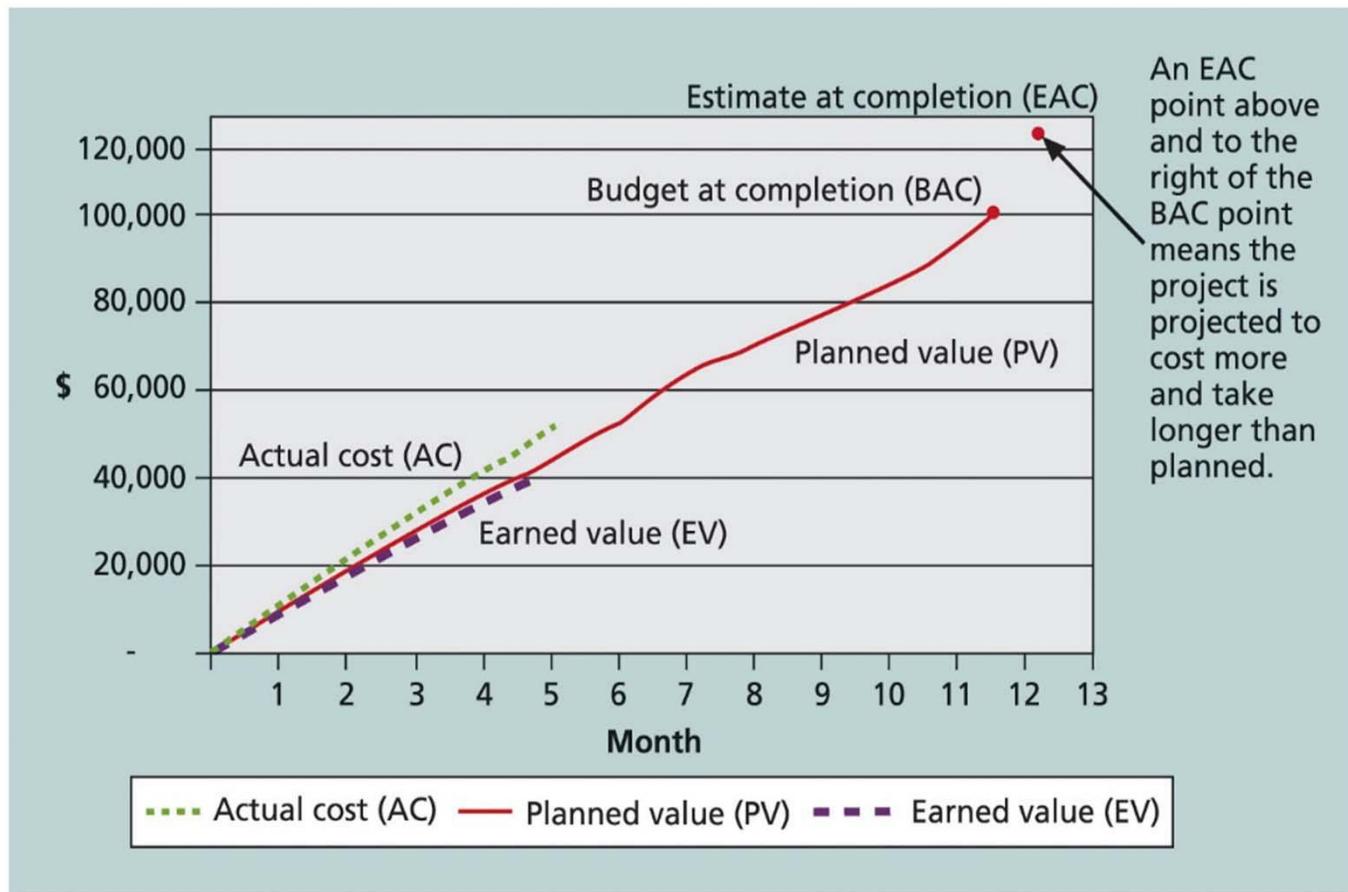
Table 7-4 Earned value formulas

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# Earned Value Management (EVM) (4 of 5)

- Important concepts
  - Cost variance (CV) is the earned value minus the actual cost
  - Schedule variance (SV) is the earned value minus the planned value
  - Cost performance index (CPI) is the ratio of earned value to actual cost
  - Schedule performance index (SPI) is the ratio of earned value to planned value
  - Estimate at completion (EAC) is an estimated cost of completing a project based on performance to date
  - To-complete performance index (TCPI) is a measure of the cost performance that must be achieved with the remaining resources to meet a specific goal

## Earned Value Management (EVM) (5 of 5)

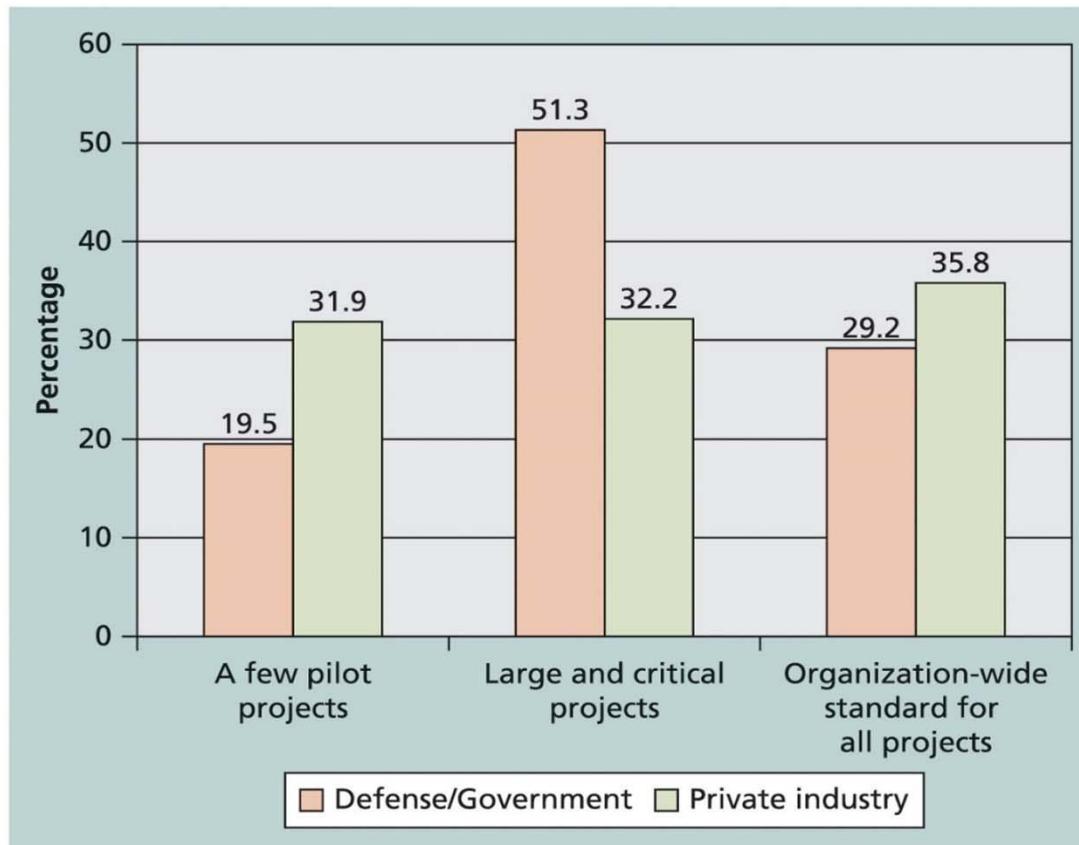


**FIGURE 7-6** Earned value chart for project after five months

## Global Issues (1 of 2)

- EVM is used worldwide, and it is particularly popular in the Middle East, South Asia, Canada, and Europe
  - Most countries require EVM for large defense or government projects, as shown in Figure 7-7
  - EVM is also used in such private-industry sectors as IT, construction, energy, and manufacturing.
    - However, most private companies have not yet applied EVM to their projects because management does not require it, feeling it is too complex and not cost effective

## Global Issues (2 of 2)



Source: Lingguang Song, "Earned Value Management: A Global and Cross-Industry Perspective on Current EVM Practice," PMI (2011), p. 36.

**FIGURE 7-7** Earned value usage

# Project Portfolio Management

- Many organizations collect and control an entire suite of projects or investments as one set of interrelated activities in a portfolio
- Five levels for project portfolio management
  - Put all your projects in one database
  - Prioritize the projects in your database
  - Divide your projects into two or three budgets based on type of investment
  - Automate the repository
  - Apply modern portfolio theory, including risk-return tools that map project risk on a curve

# Using Project Management Software to Assist in Project Cost Management (1 of 2)

- Spreadsheets are a common tool for resource planning, cost estimating, cost budgeting, and cost control
  - Many companies use more sophisticated and centralized financial applications software for cost information
- Project management software can increase a project manager's effectiveness during each process of project cost management
  - Many IT project managers use other tools to manage cost information because they do not know that they can use project management software, or they do not track costs based on a WBS, as most project management software does

# Using Project Management Software to Assist in Project Cost Management (2 of 2)

- Recent Studies on PPM Software
  - 2017 Gartner report says the market continues to grow, with annual sales over \$2.3 billion
  - Forrester estimates ROIs of 250 percent from PPM tools
  - Pfizer and Ford use PPM software to improve transparency of the many projects they manage

# Considerations for Agile/Adaptive Environments

- AgileEVM is an adapted implementation of EVM
  - Uses the Scrum framework artifacts as inputs, uses traditional EVM calculations, and is expressed in traditional EVM metrics
  - Requires a minimal set of input parameters
    - Actual cost of a project, an estimated product backlog, a release plan that provides information on the number of iterations in the release and the assumed velocity
  - All estimates can be in hours, story-points, team days or any other consistent estimate of size
    - The critical factor is that it must be a numerical estimate of some kind

# Chapter Summary

- Project cost management is a traditionally weak area of IT projects
  - Project managers must understand several basic principles of cost management to be effective in managing project costs
- Main processes
  - Plan cost management
  - Estimate costs
  - Determine the budget
  - Control costs
- Several software products can assist with project cost management