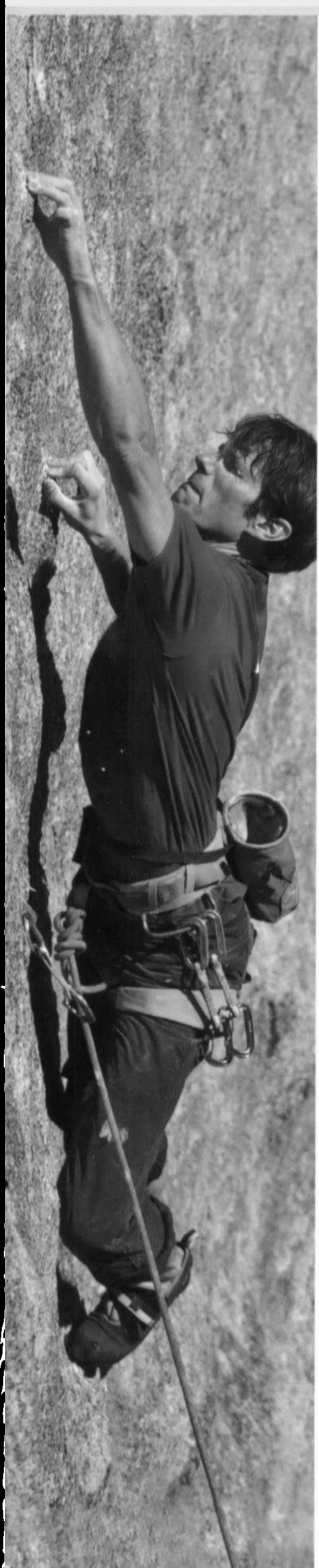
Risk and the Future of Quality
Martin, David X
The Journal for Quality and Participation; Oct 2012; 35, 3; ProQuest Central
pg. 9

The principles of risk management provide a solid framework for managing quality, too.

Risk and the Future of Quality

David X Martin



Effective risk management depends on four basic processes, each of which is a necessary precursor of the one that follows it. Together these four processes, listed below, help clarify trade-offs, consequences, uncertainties, and benefits so that risk managers can make informed, strategic decisions.

- *Assessment.* Requires the collection of all relevant information so that risk managers can pinpoint current positions and exposures.
- *The Rules of the Game.* Involves determining how and why those exposures might change.
- *Decision Making.* Comprises the process by which exposures are brought into line with agreed-upon risk appetites and tolerances given the rules of the game.
- *Re-evaluation.* Involves the continual re-examination of each of the preceding processes, as goals and conditions change.

Quality, much like risk management, requires exactly the same sort of assessment, rules recognition, decision making, and re-evaluation, and this article presents a simple framework for strategic decision making based on these four processes. Each process includes a number of fundamental principles of risk management, and in the context of those principles this articles highlights some of the ways quality and risk management can complement one another. Finally, this article turns to the role that both quality and risk management play in the formulation of effective business strategy.

Assessment

Where investments are concerned, people are generally more risk averse with their assets, and more willing to take risks when incurring liabilities. The first may result from a natural human tendency to overvalue the things they own or because of the natural human resistance—more emotional than rational—to selling an asset for less than what was paid for it. Put another way, people are more willing to risk a loss than to accept a loss. The second—that is, a greater willingness to accept risks when incurring liabilities—may result from an unfounded belief in the ability to put things right when they go wrong, or worse still, a mistaken belief that things will never go wrong. Given these natural human tendencies when people gauge their assets and liabilities, whether they are reviewing

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

investments, the condition of supply chains, or succession strategies for human resources, they should check their emotions at the door. This can be accomplished by asking two simple questions: Where we are now? and What don't we know about our present position?

- *Risk Principle One—Know Where You Are.* How can you expect to reach your goals or to manage the risks you'll encounter while trying to do so without first performing an honest assessment of your current position? Where quality is concerned, this means you'll need to move from measuring "conformance to requirements" to assessing enterprisewide conditions in the context of management's strategic goals. You may, for instance, have played a major role in ensuring that 99 percent of your products have met strict quality standards. If, however, management makes a decision to expand into new markets to ensure the long-term health of the company, quality considerations clearly play a major role in that decision. The specific products in question, the new demands on standards, and any changes in suppliers and distribution channels will all bear on quality and, therefore, those responsible should be part of the decision-making process.
- *Risk Principle Two—Know What You Don't Know.* When investing, you have to understand the limits of your knowledge, and as a corollary, question the assumptions of others. Don't presume that others know what you don't, despite what they tell you. The same is true when trying to ensure quality. The traditional quality professional's skills—such as control and improvement—have to expand to include an almost pathological curiosity about what he or she doesn't know regarding recent innovations in production, new auditing techniques, shifts in global demand, value creation, and systems management. Furthermore, the quality professional should be responsible for bringing such innovations to the attention of management.

The Rules of the Game

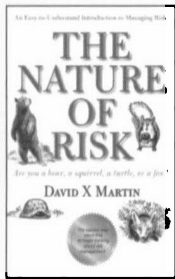
Risk management is not only a mechanism for measuring, monitoring, and preventing losses, but it also serves a broader, more active purpose. For example, when considering risk management of investments, market risk is not thought of as something that should be minimized but rather as something that should be optimized to achieve the highest risk-adjusted returns. When assuming this broader, more active role, risk managers need to set clear boundaries to ensure that they achieve the optimal amount of reward for the risk undertaken. The same is true of quality. It cannot be focused solely on trying to reduce defects or to maintain standards but must be used more broadly to help achieve the objectives of the business.

As described below, the rules of the game must be continually reviewed—not because they change but because conditions continually change around us. When determining your risk appetite, for instance—or the risk appetite of the corporation for which you work—you have not determined it for all time, but only for the present. As conditions change, and circumstances change, so will that risk appetite. Effective quality requires a similarly vigilant approach.

- *Risk Principle Three—Determine Your Appetite for Risk.* Determine how much risk you will accept in light of your goals. To paraphrase Adam Kahane, simple problems can be solved with simple tools. Complex problems require more complicated concepts and techniques. Metrics, therefore, will need to evolve as quality becomes more comprehensive, and new rules introduced as quality obtains a seat at the table where strategic decisions are made. Put another way, quality must have an audible voice when the enterprise decides how much risk to take.
- *Risk Principle Four—Demand Transparency.* One of the most important rules of the game is transparency, in both measurement and decision making. Risks—to a company's bottom line, to the quality of its products or services, and to its supply chains—should be discussed openly and fully understood by all. This transparency should extend through audits, process management, and manufacturing standards—in fact, it should extend to the entire organization and be recognized as a vital source of sustainable competitive advantage.
- *Risk Principle Five—Diversify.* Just as diversification reduces investment risks, multiple risks can also produce more consistent quality. This may seem counterintuitive at first, but quality

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

The Nature of Risk



Author: David X Martin

Abstract: Quality professionals are all but certain to encounter difficulties when they first extend their reach to include the challenges—and the opportunities—of risk management. Unfortunately, they won't find much help in the existing literature, the bulk of which focuses on financial risk, histories of financial disasters, or technical approaches. Those who wish to test the waters, however, will find this straightforward allegory a quick way to learn the basic approaches to risk management. Built around a simple fable that presents the risks forest-dwelling animals face in their habitat, this book will help readers identify their "natural" approach to risk in an easy and entertaining way. This short book also demonstrates that zero risk is unattainable and that only by proactively taking risks can you truly manage risk.

Publisher: CreateSpace

ISBN: 9781475184396

Format/Length: Softcover/67 pages

Price: $14.95

often benefits as much from risk taking as it does from risk avoidance. Seen in this light, the focus of the quality movement should also be expanded to include corporate governance and waste elimination, among others. It should also focus on the resolution of multidimensional quality problems by creating a broader definition of "total quality" that addresses all aspects of, and all risk to, business/social systems.

- *Risk Principle Six—Checks and Balances.* Quality, just like investment, depends on the continual verification of both individual and institutional checks and balances. In the future, quality will provide a holistic view of checks and balances to ensure that the organization is simultaneously meeting both its internal and external needs—that is, maintaining long-term, profitable relationships with its workforce and customers—while satisfying stakeholders' expectations.
- *Risk Principle Seven—Hard Work.* Quality, just like risk management, never ends. It must also continually reinvent itself. Once centered on tools and techniques, quality is clearly evolving toward the creation of a "culture of excellence."

Decision Making

Consider all alternatives before making decisions, and when you make a decision, don't forget to consider exit strategies as well. Not all of your decisions will lead to favorable outcomes, but the degree to which things go wrong will depend on how and when you exit—or are able to exit—a given strategy.

Toward that end, attempt to include everyone you think has a stake in the outcome when making decisions about risk management and quality. As part of that process, understand that it is your responsibility to investigate the reputations of those with whom you do business. Their reputations are every bit as important to risk management and quality.

Finally, make decisions. In other words, don't sit and watch. Make your decisions in specific timeframes, but keep in mind that your goals are certain to change over time. Put another way, it is better to be approximately right than precisely wrong.

- *Risk Principle Eight—Risk Is Everyone's Responsibility in the Decision-making Process.* To effectively manage risk, every trader building a stock position must think about the risk implications of scaling his or her trades. The operations manager must effectively reduce the operational risk when taking into account how to settle the trade. In other words, risk is everyone's responsibility in the decision-making process.

Quality needs to move in the same direction. That is, from a title or department to an integral

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

part of every division in the organization. Quality professionals also need to evolve from simply controlling products and services to becoming players in enterprisewide decision making. These transitions will require almost revolutionary cultural changes, and business cultures do not change quickly—they migrate. They depend on top-down changes from senior management and require fundamental changes that only senior management can effect. For example, where people are paid based on performance, money tends to be a strong motivational factor. If quality standards instead were written into all job descriptions and performance goals, employees would begin to work differently. Further, if their compensation were based on performance against quality standards, the culture of the company would quickly change, with everyone starting to take individual responsibility for quality.

Re-evaluation

Continually monitor the outcomes of your decisions and of the decisions made on your behalf. Never stop asking questions. That said, understand your boundaries—which can also be defined as the limits of your responsibilities—and the boundaries of those who work for you. Finally, learn from your mistakes. Success frequently offers less information than failure. Learn to treat your mistakes, and the mistakes others make on your behalf, as charts to successfully navigate the future.

- *Risk Principle Nine—Monitor Outcomes Continuously and Learn From Your Mistakes.* Acknowledging your mistakes leads to better decision making. In risk management, it is common to do post-mortems on errors. A large error is never caused by a single factor. It is always a result of a confluence of factors, most of which are exposed only when you peel back the different layers of the process and evaluate the controls that should have prevented the error in the first place. Quality needs to follow this example—that is, to become more self-conscious in terms of evaluating errors and more willing to treat lessons learned as valuable takeaways. Quality also needs to look across the organization to determine where the same error might occur and to ensure that the proper safeguards are in place.

Conclusion

Successfully "de-risking" your investments, to say nothing of your life plans, means preparing so that when lightning strikes—as it almost certainly will at one time or another—your plans, and the processes you have put in place to accomplish them, will make courage unnecessary. In other words, process will protect you from jeopardizing your goals by having to make decisions in the heat of the moment, without first considering the risks. Those who do not are usually caught without a chair when the music stops; those who do are already sitting down.

Wise men and women understand that certain risks are necessary to achieve their goals. They tend to determine their appetite for risk, and make their decisions regarding it, before the storm arrives because they understand that doing nothing, in and of itself, incurs a risk. This is as true of our personal lives as it is in the world of finance, manufacturing, or services. If quality is to receive not only a seat, but also a voice at the proverbial table of management, it needs to address not only "risks to quality," but also "risks to the corporation." Quality professionals already have the skills to intelligently identify and mitigate risk, but they need to use those skills in a more strategic manner.

David X Martin

David X Martin is an internationally recognized expert on risk management and a senior advisor at the global management consulting firm Oliver Wyman. His long career includes stints at PricewaterhouseCoopers (PWC), Citibank, and AllianceBernstein. Martin was the founding chairman of the Investment Company Institute's Risk Committee (ICIRC) and a member of the Sanctions Subcommittee of the U.S. Department of State's Advisory Committee on International Economic Policy. He is an adjunct professor at New York University's Stern School of Business. Martin has published numerous white papers on compliance and risk, enterprise risk management, corporate governance, and cyber security. His latest book, The Nature of Risk, *is now available. Contact Martin at* **davidxmartin@aol.com.**

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.