

The role of variable pay in employee motivation

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Variable pay is an essential tool that companies use to motivate employees, achieve business goals, and foster a results-oriented culture. It is becoming increasingly popular in Latvia and the Baltics, where companies are seeking flexible ways to respond to market changes while also retaining top talent.

What is variable pay?

Variable pay is additional compensation awarded based on the performance of an individual employee, a team, or the company as a whole. It can include sales commissions, quarterly or annual bonuses, profit-sharing (a percentage of company profits), long-term incentive plans such as stock awards or stock options, and more. Such payments must be transparent, predictable, and tied to clearly defined criteria.

The primary reason companies implement variable pay is to link compensation with results, ensuring that employees are rewarded more generously when they help achieve the company's goals. In essence, variable pay is closely connected to the achievement of individual or group targets (KPIs). For employers, it also offers flexibility in managing costs — for example, if sales targets are not met, the variable component is reduced or not paid out at all. This also encourages employee engagement and accountability for their responsibilities.

Variable pay is especially effective for sales professionals, as performance in this area is directly measurable and influenced by the individual's effort, network, and sales strategy. Long-term incentive tools — such as deferred bonuses or stock options — are particularly common for executives, whose work affects strategic goals that are often neither immediately measurable nor short-term in nature. However, the use of variable pay is becoming more popular across other roles as well, such as project managers, IT specialists, and finance professionals, where compensation is increasingly tied to completed goals or tasks.

In essence, the employer is saying: *"We pay for well-executed work, not just work completed."*

When looking at examples of KPIs, it becomes clear that they can be tailored to the nature of the job as well as the industry. Moreover, KPIs are not limited to employees whose performance depends on fixed metrics such as sales volumes. KPIs can include indicators such as customer satisfaction scores (NPS), profit growth, project completion within time and budget, acquisition of new clients, employee retention rates, system availability, incident resolution time, and, of course, sales volume or growth (in %).

Are there only benefits, or also risks?

The benefits of implementing variable pay:

- Better motivation and productivity
- Greater transparency regarding goals

- Ability to differentiate pay according to employee performance
- Opportunity to grow along with the company's growth

However, it is also important to consider the potential risks, including the following:

- Incorrectly defined KPIs can prevent achieving company goals, create unhealthy competition, and even lead to additional costs;
- Excessive reliance on the variable component can cause instability and, contrary to its purpose, demotivate employees;
- Clear criteria for payments must be established; otherwise, insufficient communication can reduce trust and motivation;
- Relying solely on individual motivation to meet goals may be insufficient to drive overall company growth.

A bit of statistics

According to Fontes studies on compensation for work in Latvia over recent years, more than 60% of companies in Latvia use some form of variable pay, with the most popular being the annual bonus.

According to a study by Compensation Advisory Partners¹, which analysed 120 large companies in the USA, 97% of them use long-term variable pay plans for executives. These plans are mostly based on:

- over three years of performance periods;
- increase in stock value or profit growth;
- increase in market share;
- achievement of ESG goals.

The importance of variable compensation in publicly listed companies

The structure of variable compensation, especially long-term bonuses, in publicly listed companies is not only a motivational tool but also a matter of corporate governance and shareholder trust.

Long-term variable compensation for management often includes stock options or stock grants, long-term bonus plans based on achieving targets, or even a combination of both — performance-based stock grants paid out over a 3–5 year period if specific KPIs are met.

Long-term bonuses that depend on stock price appreciation or even form part of the granted benefit help ensure that management decisions are not focused solely on short-term profits but also on the sustainable growth of company value, thereby motivating managers. Components of long-term variable compensation also serve as a strong motivating mechanism that helps retain top-level executives and secures their involvement in the company's long-term development. Often, these benefits are significant, sometimes exceeding one year's salary.

From a governance perspective, publicly listed companies often disclose their management compensation structure, and investors expect it to be transparent, justified, and linked to results. This is ensured through a long-term variable compensation structure based on measurable and transparent goals and KPIs.

In practice, there are several examples of such a model. For instance, Apple Inc.'s management compensation structure heavily relies on stock options or stock awards, which are awarded or paid out if specific financial and market goals are met. The management compensation of Unilever and Volkswagen

includes a variable portion based on the achievement of the company's long-term strategic goals, including ESG indicators.

¹ Long-term Incentive Plans – Payouts and Performance Alignment - Compensation Advisory Partner