



CVA and DVA under FRS 102.

The FRC's Periodic Review 2024 amendments introduce a new fair value measurement framework into FRS 102, based on IFRS 13. For accounting periods beginning on or after 1 January 2026, entities holding derivatives should incorporate credit and debit valuation adjustments where material. The standard, the methodology, and the audit expectation have all changed.

EXECUTIVE SUMMARY

THE STANDARD HAS CHANGED

FRS 102 has adopted the IFRS 13 fair value framework. Fair value is now an exit price, and a liability is measured at what it would cost to transfer rather than to settle, which brings an entity's own credit standing into the value of its own obligations for the first time. For entities holding derivatives, CVA and DVA should be used where material, for periods beginning on or after 1 January 2026.

METHODOLOGY REQUIREMENTS

CVA and DVA should reflect the assumptions a market participant would use, which points to market-implied default probabilities and volatilities rather than internal or historical estimates. Calculation is generally conducted at netting-set level rather than trade by trade, using simulation. Credit curves should be constructed where no observable market data exists.

AUDIT AND REPORTING RISK

Auditors have applied IFRS 13 to their IFRS clients since 2013 and are now applying comparable scrutiny to FRS 102 entities. The FRC has identified inadequate fair value methodology as a recurring area of concern. Entities without a documented, compliant approach are materially exposed.

A NOTE ON SOURCES

The requirements discussed here are those of FRS 102 itself, principally the new Section 2A on fair value measurement. Section 2A is based on IFRS 13 but is a shorter document and does not reproduce it in full. References to IFRS 13 in this briefing are to the framework Section 2A derives from, and to the interpretation and audit practice that has grown up around it since 2013, rather than to requirements a UK GAAP preparer applies directly.

THE REGULATORY CHANGE

The standard has changed.

Amendments to FRS 102 and other FRSs, Periodic Review 2024, were issued by the Financial Reporting Council on 27 March 2024. The amendments take effect for accounting periods beginning on or after 1 January 2026, with early application permitted provided all of the periodic review amendments are applied at the same time. For any organisation that holds derivatives and prepares accounts under FRS 102, the implications are material and the timeline is immediate.

The fair value guidance in FRS 102 has been replaced wholesale. A new Section 2A, based on IFRS 13, governs how fair value is measured. What must be measured at fair value has not changed, and continues to be determined by the financial instruments sections of the standard.

Fair value is now defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This is commonly referred to as an exit price. The definition has direct consequences for how derivatives are measured. A derivative is no longer valued simply by discounting expected cash flows. It must be valued as a market participant would price it today, incorporating the adjustments that participant would demand in order to take on the position.

The change is particularly significant on the liability side. Under the previous definition, the fair value of a liability was framed in terms of what it would cost to settle. It is now framed in terms of what it would cost to transfer. The distinction matters because settlement is a payment at par and transfer is a price, and the price at which an obligation changes hands depends on the standing of the party that owes it. Own credit risk therefore enters the measurement of an entity's own liabilities for the first time.

Two adjustments sit at the heart of this requirement.

CVA**Credit Valuation Adjustment**

CVA reflects the risk that a counterparty defaults before a derivative reaches maturity. If a counterparty owes money under a derivative contract and defaults, the surviving party does not recover the full amount owed. CVA is the present value of that expected loss, measured on a risk-neutral basis using market-implied default probabilities rather than a real-world or historical expectation of default. Under an exit price framework, a market participant acquiring a derivative asset would price the credit risk of the obligor into what it was prepared to pay. The measurement in the accounts must reflect the same adjustment.

DVA**Debit Valuation Adjustment**

DVA is the corresponding adjustment on the liability side. Because a liability is now measured at what it would cost to transfer rather than to settle, its value reflects the reporting entity's own credit standing. The logic is one of symmetry. A counterparty pricing a derivative will incorporate the credit risk of the reporting entity into its own valuation. The reporting entity's accounts should reflect the same economic reality from its own perspective.

Together, CVA and DVA constitute what practitioners refer to as bilateral CVA. A rigorous bilateral calculation conditions each leg on the survival of the other party, so that CVA is computed across the scenarios in which the counterparty defaults first and DVA across those in which the reporting entity does. Many implementations compute the two legs independently and net the results. That is a simplification, and where the credit quality of the two parties differs materially, its effect should be tested rather than assumed to be immaterial.

METHODOLOGY**Market-implied inputs should be used.**

It is not enough to make an adjustment. The adjustment has to be built on the assumptions a market participant would use, which in practice means market-implied inputs: default probabilities derived from credit spreads observed in CDS or bond markets, and volatilities derived from options markets.

Internal credit assessments, regulatory probability of default estimates prepared for capital purposes, and long-run historical default statistics are not, on their own, a market-implied basis. The difference is not a technicality. A traded credit spread compensates the holder not only for the actuarial expectation of loss but for bearing the uncertainty around it, which is why the default probability implied by a CDS spread is typically a multiple of the observed historical default rate for the same credit quality. A market participant charges for that

uncertainty, so a measurement built on historical default statistics will understate the adjustment a market participant would demand. The same holds for volatility: an implied volatility sits above realised volatility for the same reason.

Where no observable credit data exists for a given name, unobservable inputs are unavoidable. They should be constructed and calibrated so as to approximate what a market participant would use, on a current rather than a through-the-cycle basis, and the derivation should be documented.

Footnote. Whether funding valuation adjustment and the other XVAs form part of fair value for financial reporting purposes remains contested. Prevailing practice among non-financial FRS 102 preparers is to recognise CVA and DVA only. Any decision to include or exclude further adjustments should be documented and applied consistently.

COMPUTATION

The computational challenge.

CVA and DVA cannot be computed using simplified analytical methods for any portfolio of meaningful complexity. The adjustments depend on the distribution of potential future exposures across the remaining life of a derivatives portfolio, under a large and representative set of market scenarios. This requires Monte Carlo simulation: a probabilistic model of how interest rates, foreign exchange rates, inflation, and other relevant risk factors evolve over time, producing an exposure distribution at each future date.

The primary input into CVA is the expected exposure profile: the discounted expectation, at each future date, of the portfolio value where that value is positive to the reporting entity. That profile is integrated against the counterparty's marginal default probabilities over the life of the portfolio and scaled by loss given default. The expected negative exposure profile, representing the portfolio's value from the counterparty's perspective, serves the corresponding role for DVA.

-
- 1 Calculate at netting-set level where legally enforceable netting arrangements exist.**
Under an ISDA Master Agreement, the amount actually at risk on counterparty default is the net close-out amount across all transactions covered by that agreement, not the sum of the individual positive positions. A market participant prices credit risk by reference to the loss it would actually suffer, so the adjustment should follow the netting. Computing CVA trade by trade and aggregating the results overstates the adjustment, and correspondingly understates DVA. Enforceability should be established before netting benefit is taken.
-

- 2 Capture cross-asset correlations.** For portfolios containing instruments across multiple asset classes, the joint evolution of risk factors determines how individual transaction exposures offset one another within the netting set. A simulation framework that models risk factors independently will misstate the net exposure profile.
- 3 Refresh at each reporting date.** CVA and DVA are not static calculations. Credit spreads change as market conditions evolve, and exposures change as rates move and time passes. The methodology should be applied consistently from period to period, and movements between periods should be explainable to auditors.

DATA

The credit curve problem.

For a derivative held under an ISDA Master Agreement with a bank counterparty, a market-implied credit curve for that counterparty is generally available: the major dealers have liquid single-name CDS quotes and publicly traded senior unsecured debt. The harder problem for most FRS 102 preparers is the curve for their own credit, which is required for DVA. Local authorities, housing associations, pension funds, charities, and most mid-market corporates have no observable single-name credit spread of their own. For these entities, a market-implied credit curve cannot be sourced from a terminal. It must be constructed.

Construction requires a structured proxy methodology drawing on sector and rating-based CDS indices, peer group bond spreads, and third-party model-implied spread data from specialist providers. Where bond spreads are used, they should be adjusted for the components that do not represent credit: an observed bond spread also compensates the holder for liquidity and funding, which is why a CDS to bond basis exists, and using an unadjusted asset swap spread as a default intensity will generally overstate credit risk. The methodology should produce a full term structure of default probabilities consistent with what a market participant would use, calibrated to current market conditions rather than historical averages, and documented in sufficient detail that an auditor can assess whether the inputs and approach are appropriate.

The recovery assumption matters as much as the spread. The loss given default applied in the loss leg should be consistent with the recovery rate assumed when bootstrapping default probabilities from spreads, since a spread only implies a default intensity once a recovery assumption is fixed. An inconsistency between the two is a common and easily identified weakness.

This is not a one-time exercise. Credit spreads change as market conditions evolve. Exposures change as rates move and time passes. CVA and DVA should be refreshed at each reporting date, and the methodology should be applied consistently from period to period. Auditors will examine movements between periods and will require explanations where figures change materially.

KEY CONSIDERATIONS

What FRS 102 entities need to address.

Any entity holding derivatives and reporting under FRS 102 faces the same set of practical challenges. The requirements do not vary by sector: they apply wherever a derivative is on the balance sheet and measured at fair value.

ISDA netting sets

Many entities hold derivatives under ISDA Master Agreements, which create legally enforceable close-out netting: on default, the net amount across all covered transactions determines the exposure. Where such arrangements exist and their enforceability is established, the credit adjustment should be determined at netting-set level, because that is the loss a market participant would price. Instrument-by-instrument calculation overstates CVA and understates DVA.

Counterparty credit curves

Where a counterparty has liquid CDS quotes or publicly traded debt, a market-implied credit curve is observable and can be used directly as the basis for CVA inputs. Bond-derived spreads should be adjusted to strip out the liquidity and funding components that a CDS spread does not contain.

DVA and own credit risk

Most FRS 102 entities have no publicly traded credit instruments of their own. The DVA credit curve, reflecting the reporting entity's own credit standing, should be constructed using a proxy methodology drawing on sector indices, comparable bond spreads, and third-party model data. For entities with material negative mark-to-market positions, DVA can be a significant adjustment that reduces the reported net derivative liability.

Balance sheet and covenant implications

Fair value movements on derivatives flow through the balance sheet and can affect financial covenant headroom, board risk reporting, and lender relationships. CVA and DVA should be considered not only as an accounting requirement but as inputs into covenant compliance analysis and the treasury risk framework. Where hedge accounting is applied, entities should also consider how CVA and DVA interact with effectiveness testing and designation, since the adjustments change the fair value of the hedging instrument being tested.

AUDIT RISK**The audit and reporting risk.**

IFRS 13 has applied to entities reporting under full IFRS since 2013. In the period after it took effect, audit firms systematically challenged banks and large corporates on the adequacy of CVA methodology, on the use of market-implied inputs, and on whether the adjustment was being computed at the correct level. FRS 102 now rests on the same framework, and the same scrutiny is arriving with it.

The FRC's thematic review of fair value measurement identified a need for measurements to reflect market participants' assumptions rather than the entity's own, and found scope for improvement in disclosure of valuation approach, underlying assumptions, management judgement and estimation uncertainty. Fair value measurement and financial instruments both feature among the FRC's most frequently raised issues, and the FRC's more recent thematic work extends to FRS 102 preparers as well as IFRS reporters, with particular attention to fair value measurements based on unobservable inputs.

For any organisation holding derivatives and reporting under FRS 102, the effective date has arrived. The requirements apply for accounting periods beginning on or after 1 January 2026. Entities that have not yet established a compliant methodology are already behind. The question is no longer whether an adjustment is needed, but whether the approach currently in place will withstand an auditor who has been testing these calculations for a decade.

HOW CENTRUS CAN HELP

End-to-end CVA and DVA for FRS 102 entities.

Centrus provides compliant, auditor-ready CVA and DVA computation for entities reporting under FRS 102, designed for organisations that require rigorous, documented figures without building the requisite infrastructure in-house.

Credit curve construction

For counterparties and reporting entities without observable market data, Centrus constructs bespoke credit curves using a structured proxy methodology drawing on sector CDS indices, peer bond spreads, and third-party model data. Bond-derived inputs are adjusted for liquidity and funding components, recovery assumptions are applied consistently between the default probability bootstrap and the loss leg, and all curves are calibrated to market-implied parameters and fully documented for audit review.

Monte Carlo simulation

Centrus runs full Monte Carlo simulation at netting-set level, modelling the joint evolution of relevant market risk factors across the full remaining life of the derivatives portfolio. The simulation is calibrated to current implied volatilities and forward curves, correctly captures enforceable netting under ISDA Master Agreements, and produces expected exposure profiles on both sides as the basis for CVA and DVA respectively.

Auditor-ready reporting

Outputs are delivered as fair value adjustments in sterling, accompanied by comprehensive methodology documentation, the credit curves applied, key assumptions, and sensitivity analysis. Centrus engages directly with audit teams where required to support technical review of the methodology and inputs, reducing the burden on finance teams during the year-end process.

Ongoing coverage

CVA and DVA are not one-time calculations. Centrus provides periodic recalculation at each reporting date, with period-on-period attribution so that movements in fair value adjustments can be explained by reference to changes in credit spreads, portfolio exposures, and remaining tenor. Consistent methodology across periods is maintained as standard.



**Hamish
Martin**

Senior
Valuations
Associate



**Joe
Kennedy**

Senior
Valuations
Associate

To discuss your derivatives portfolio and CVA/DVA requirements, contact the Centrus Risk Advisory & Analytics team.

centrusadvisors.com



This briefing is produced by Centrus for information purposes only and does not constitute financial, accounting or legal advice. © Centrus 2026. centrusadvisors.com