ENHANCING AUDIT QUALITY AND ISLAMIC FINANCE COMPLIANCE IN ISLAMIC FINANCIAL INSTITUTIONS: A CONCEPTUAL FRAMEWORK FOR EMERGING MARKETS

Raximova Onaxon Ozod qizi
Accounting, Economic Analysis and Audit, PhD Candidate
Tashkent State University of Economics, 08.00.08

ABSTRACT

Islamic financial institutions (IFIs) face an assurance problem that conventional banks do not: their financial statements must present a true and fair view while their products and operations must simultaneously conform to Islamic finance rules. This dual obligation generates audit risks-non-compliant income, mislabeled contracts, co-mingled funds, and governance opacity-that a single financial audit cannot capture. This paper develops a conceptual framework for enhancing audit quality and Islamic finance compliance in IFIs, with particular attention to emerging markets. Building on established audit-quality theory and Islamic finance governance standards, the framework integrates three assurance pillars-an internal Islamic finance audit function, the external financial audit, and the institution's governance boards-into a coordinated dual-layer assurance system anchored in strong internal control. The paper then analyzes four drivers of audit quality-auditor competence, independence, standard harmonization, and disclosure transparency-and argues that each operates differently across the financial and compliance layers. Turning to application, it examines the regulatory challenges and resource constraints characteristic of developing banking sectors, using the Central Asian and Uzbek context as an illustrative case, and proposes proportionate, phased solutions. The analysis yields actionable implications for central banks, financial regulators, and audit practitioners seeking to build credible assurance ecosystems where Islamic finance is nascent. The paper's contribution is an integrative, governance-anchored model that treats financial and Islamic finance assurance as complementary rather than parallel.

Keywords: Audit quality; Islamic finance governance; Internal control; Islamic financial institutions; Dual-layer assurance; Emerging markets.

INTRODUCTION

Islamic finance has grown from a niche activity into a globally significant segment of the financial system, and Islamic financial institutions now intermediate substantial assets across the Gulf, South and Southeast Asia, and, increasingly, the emerging economies of Central Asia and Africa. IFIs intermediate on the basis of risk-sharing, asset-backing, and the prohibition of interest (riba) and excessive uncertainty (gharar). Their legitimacy therefore rests on two promises made simultaneously: that the institution is financially sound and fairly reported, and that its products and conduct conform to Islamic finance rules. The credibility of both promises depends on audit-and it is precisely here that the conventional assurance model is insufficient.

The audit risks confronting IFIs are qualitatively distinct. First, contract-substance risk arises because an instrument labeled Murabaha, Ijarah, or Mudaraba may, in its execution or economic substance, depart from the requirements that make it compliant. Second, non-compliant income risk requires that any income earned from impermissible sources be identified, quantified, and purified-channeled away from shareholders-raising recognition, measurement, and disclosure questions that ordinary financial auditing does not pose. Third, profit-sharing and investment-account risk concerns the co-mingling of funds and the fair allocation of profit to investment account holders, whose quasi-equity stake has no clean analogue in conventional banking. Fourth, governance risk arises where the institution's Islamic finance supervisory board lacks independence or operational capacity, or where its expert conclusions are approved ex ante but not verified in execution. None of these risks is fully addressed by financial reporting and auditing standards alone.

These risks motivate a dual-layer conception of assurance. The first layer, financial assurance, provides an opinion that the financial statements give a true and fair view under the applicable framework (IFRS or AAOIFI Financial Accounting Standards). The second layer, Islamic finance compliance assurance, provides assurance that products and operations conform to Islamic finance rules as interpreted through the supervisory board's expert conclusions. Critically, the two layers are interdependent rather than parallel: financial figures depend on compliance determinations-for instance, whether an income stream is recognizable or must be purified-while compliance conclusions depend on financial evidence, such as the tracing of fund flows through the institution's records. A single-layer model, however well executed, leaves an assurance gap at exactly the point where the two obligations intersect.

Prior research has tended to treat financial audit and Islamic finance audit as separate domains, and existing governance frameworks-AAOIFI governance standards, the Islamic Financial Services Board's guiding principles, and leading national frameworks-address compliance oversight while under-specifying its integration with the financial audit and calibrating their requirements to mature markets. Emerging markets, where Islamic finance is often being built on a conventional and post-transition banking base, face additional binding constraints. Against this backdrop, this paper (i) articulates the unique audit risks and the case for dual-layer assurance; (ii) proposes an integrated, three-pillar conceptual framework; (iii) analyzes the drivers of audit quality across both layers; (iv) applies the framework to emerging markets, using Uzbekistan and the wider Central Asian setting as an illustrative case; and (v) derives actionable implications for central banks, financial regulators, and audit practitioners.

The dominant conception of audit quality derives from DeAngelo (1981), who defined it as the joint probability that an auditor both detects a material misstatement (a function of competence) and reports it (a function of independence). Subsequent frameworks broadened this dyad: the IAASB's Framework for Audit Quality (2014) organizes quality around input, process, output, and contextual factors, while Francis (2004, 2011) situates quality within a multi-level system spanning the individual auditor, the engagement, the firm, and the institutional environment. These frameworks were developed for conventional financial audit, and they translate only imperfectly to compliance auditing, where "misstatement" becomes "non-compliance," and where the reporting channel runs inward through governance boards rather than outward through a public opinion.

A parallel literature addresses Islamic finance governance and audit. AAOIFI's governance standards establish the Islamic finance supervisory board, the internal Islamic finance review, and the associated disclosures; the IFSB's guiding principles emphasize competence, independence, confidentiality, and consistency in Islamic finance governance systems; and the centralized-council model-a national advisory body coupled with institution-level boards and mandatory internal and external compliance review-is widely regarded as a benchmark for coherence. Empirical and normative scholarship nonetheless documents recurring weaknesses: an "expectations gap" between what compliance audit is assumed to deliver and what it delivers in practice, a shortage of dually-qualified auditors, weak supervisory-board independence, the absence of a standardized compliance-audit methodology, and inconsistent disclosure (Karim, 1990; Grais & Pellegrini, 2006; Kasim, Ibrahim, & Sulaiman, 2009; Mollah & Zaman, 2015).

These two literatures rarely meet. Financial-audit-quality research seldom incorporates compliance assurance, and Islamic finance governance research seldom engages the determinants of audit quality directly. This paper positions dual-layer assurance at their intersection and asks a question neither literature answers on its own: how should audit quality be conceived when two different kinds of assurance must be produced coherently, and how can that conception be operationalized where institutional capacity is still forming?

The proposed framework rests on three propositions. First, assurance in IFIs is inherently dual-financial and compliance-because the institution makes two simultaneous promises. Second, the two layers are interdependent and must be coordinated rather than siloed. Third, coordination is achieved through governance, using an adapted three-lines-of-defense logic in which internal control is the foundation and the governance boards are the integrating mechanism. Figure 1 depicts the framework.

National regulator (Central Bank) + National Islamic finance advisory council

↓

Board of Directors • Audit Committee

↓

LAYER 1 - FINANCIAL ASSURANCE		**LAYER 2 - ISLAMIC FINANCE COMPLIANCE ASSURANCE**
Audit Committee oversight (financial governance)		Islamic finance supervisory board (ex-ante approval; expert conclusions)
↓		↓
Internal Audit - financial (3rd line of defense)	↔	Internal Islamic finance review/audit (ex-post verification)
↓		↓
External financial auditor (independent opinion)		External Islamic finance audit (where mandated)
↓		↓
Opinion: true & fair view (IFRS / AAOIFI FAS)		**Opinion: Islamic finance compliance**
↓		↓

Integrated assurance to stakeholders: investment account holders, shareholders, regulators, public

Figure 1. The dual-layer assurance framework for Islamic financial institutions. The internal financial and Islamic finance audit functions coordinate through a shared audit trail (↔).

Pillar A - the internal Islamic finance audit and review function. Located within the institution, this function performs ongoing, ex-post verification that executed transactions and processes conform to the supervisory board's expert conclusions and to Islamic finance rules. It is distinct from the ex-ante role of the supervisory board, which approves structures before they are offered; the internal function checks that what was approved is what is actually done. To preserve objectivity it should report functionally to the audit committee and the supervisory board rather than to executive management.

Pillar B - the external audit. The external financial auditor expresses an independent opinion on whether the financial statements give a true and fair view under the applicable framework. In jurisdictions that mandate it, an external Islamic finance audit provides independent assurance on compliance, complementing the internal function. External audit contributes the two attributes that internal assurance cannot fully supply on its own: independence from management and public accountability.

Pillar C - the governance boards. Financial governance is exercised by the board of directors and its audit committee; compliance governance is exercised by the Islamic finance supervisory board, which issues expert conclusions ex ante and reviews the annual compliance report. At the system level, a national or central Islamic finance advisory council can harmonize expert conclusions across institutions, reducing fragmentation. The governance pillar is the framework's integrating layer: it commissions both kinds of assurance, receives both, and is accountable for closing any gap between them.

The framework maps onto an adapted three-lines-of-defense model. The first line comprises business units and management, operating the internal controls-including the compliance controls embedded in product design and transaction processing-that are the true foundation of assurance. The second line comprises risk management and compliance functions, including a dedicated Islamic finance compliance unit. The third line is internal audit, encompassing both financial and Islamic finance audit, which provides independent assurance to the board. External assurance-the external financial auditor and, where mandated, the external Islamic finance auditor-together with the regulator, sits outside the three lines. A distinctive feature of the IFI setting is that the supervisory board straddles governance and a second-line advisory role; consequently, the board's independence and the operational strength of the internal review unit are the load-bearing elements of the whole structure.

Three mechanisms convert two separate assurance activities into one coherent system. The first is a shared audit trail: financial and compliance auditors should draw on a common transaction record, because determinations such as the identification of non-compliant income require compliance judgment and financial tracing in combination. The second is integrated reporting to the audit committee through a combined assurance map that displays coverage across both layers, exposing gaps and eliminating duplication. The third is a defined escalation path that allows the internal Islamic finance auditor to raise unresolved non-compliance to the supervisory board and the audit committee, and that carries material issues onward to the regulator. Table 1 summarizes the pillars, their actors, mandates, and outputs.

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Table 1. The three pillars of the dual-layer assurance framework.

Pillar	Principal actor(s) and role	Mandate and scope	Primary output
A. Internal Islamic finance audit/review	Internal review unit; functional reporting to audit committee and Islamic finance supervisory board	Ex-post verification that executed transactions and processes conform to expert conclusions and Islamic finance rules	Internal compliance reports; escalation of breaches
B. External audit	External financial auditor; external Islamic finance auditor where mandated	Independent opinion on true and fair view; independent compliance assurance where required	Audit opinion; external compliance report
C. Governance boards	Board/audit committee (financial); Islamic finance supervisory board (compliance); national advisory council (system)	Ex-ante approval of structures; oversight of internal and external audit; harmonization of expert conclusions	Expert conclusions; annual compliance report; oversight

Adapting audit-quality theory to the dual-layer setting, four drivers are decisive. The central analytical point is that each driver behaves differently across the financial and compliance layers, so that raising overall audit quality requires attention to both expressions of every driver rather than to the financial layer alone.

Competence in an IFI spans two knowledge bases: financial competence (accounting, IFRS and AAOIFI Financial Accounting Standards, and auditing standards) and Islamic finance competence (knowledge of the underlying contracts and the ability to assess their compliance). The binding constraint is the dual-competency gap-few professionals possess both in depth. Practical responses include joint qualification pathways, structured continuing education, and mixed audit teams that pair a chartered accountant with an Islamic finance scholar under a clear reliance framework, so that each may appropriately rely on the other's work while remaining accountable for the integrated conclusion.

Independence operates at three points. Supervisory-board independence is the most distinctive concern: members are typically remunerated by the institution they oversee and often serve on many boards, creating both conflict-of-interest and consistency problems. Internal audit independence depends on functional reporting to the audit committee rather than to management. External auditor independence faces the familiar threats of self-review, familiarity, and fee dependence, which are sharpened in small markets served by few firms. Because the compliance layer reports inward to boards rather than outward through a public opinion, its independence is protected chiefly by governance design-reporting lines, rotation, and disclosure-making board structure, rather than market discipline, the decisive safeguard.

Two harmonization problems bear on quality. The first is financial-reporting harmonization-the well-documented divergence between AAOIFI Financial Accounting Standards and IFRS. The second, less discussed but equally consequential, is the absence of a single, globally adopted methodology for Islamic finance compliance audit: unlike financial auditing, compliance auditing lacks uniform standards governing scope, procedures, and reporting, so practice varies widely across institutions and jurisdictions. AAOIFI's auditing and governance standards and the IFSB's principles provide a workable basis, but adoption is uneven. Greater harmonization improves comparability and the reliability of the assurance produced.

Transparency is the driver that converts internal assurance into external credibility and, in doing so, disciplines the other three. Both layers generate outputs that stakeholders must be able to see: the external audit opinion and financial-statement disclosures on the financial side; and, on the compliance side, the supervisory board's annual report, the disclosure of non-compliant income and its purification, and disclosure of the governance structure together with the qualifications and independence of board members. Where these outputs are disclosed fully and consistently, competence and independence are subjected to external scrutiny; where they are not, weaknesses in the other drivers remain hidden. Table 2 maps the four drivers across the two assurance layers.

Table 2. Drivers of audit quality across the two assurance layers.

Driver	**Financial assurance layer**	**Islamic finance compliance layer**
Auditor competence	Accounting, IFRS/AAOIFI FAS, and auditing standards	Contract knowledge and compliance assessment; dual-competency requirement met via mixed teams
Independence	External-auditor independence; internal audit functional reporting to the audit committee	Supervisory-board independence (remuneration, multiple mandates); protected mainly by governance design
Standard harmonization	AAOIFI FAS versus IFRS convergence	Absence of a single global compliance-audit methodology; uneven AAOIFI/IFSB adoption
Disclosure transparency	Audit opinion and financial-statement disclosures	Compliance report; non-compliant income and purification; board composition and independence

In mature Islamic finance markets, the legal framework, standards adoption, talent pool, and audit-firm capacity are largely in place, so the framework above can be implemented more or less directly. Emerging markets-especially those where Islamic finance is nascent and is being built on a conventional, post-transition banking base-face binding constraints that reshape how the framework can be applied. Uzbekistan and the wider Central Asian setting offer an instructive case.

Uzbekistan has a large Muslim-majority population and a banking system historically organized on conventional foundations. Interest in Islamic finance has grown markedly, supported by multilateral institutions such as the Islamic Development Bank and the International Finance Corporation, and the authorities have moved toward enabling legislation while non-bank Islamic finance-leasing and microfinance in particular-and Islamic "windows" have served as early entry points. The market's ambition, however, currently outpaces its assurance infrastructure: the institutions, standards, and human capital required to deliver credible dual-layer assurance are still at an early stage of development. The following subsections diagnose the principal obstacles and propose proportionate solutions; Table 3 consolidates the analysis.

The foremost challenge is the absence of a comprehensive legal and regulatory framework specific to Islamic finance and its assurance, including any explicit mandate for a compliance audit. Related frictions include the lack of a national advisory body to harmonize expert conclusions-so that interpretations risk fragmenting across institutions-partial or absent adoption of AAOIFI and IFSB standards and an unclear interaction with existing IFRS-based reporting and national audit law, and tax and legal frictions such as the double transfer taxation that can arise on the asset sales underlying Murabaha-type structures, which distorts product design and complicates audit.

5.2 Resource and capacity constraints

Capacity constraints are equally binding. There is an acute shortage of dually-qualified auditors and Islamic finance scholars and a thin domestic training infrastructure to remedy it. Audit-firm capacity is limited, and specialized Islamic finance audit practices have shallow penetration. The initial market is small, which makes full-scale governance costly relative to business volume, and transaction-level data and IT systems for monitoring compliance are underdeveloped.

These constraints call for proportionate, phased implementation rather than wholesale transplantation of a mature-market model. Enabling regulation should begin with clear rules for Islamic windows and non-bank Islamic finance, embedding a compliance-audit requirement scaled to institution size, and expand toward full-fledged Islamic banks as capacity grows. A national Islamic finance advisory council, anchored in the central bank, can issue and harmonize expert conclusions, reducing duplication and building consistency along the lines of the centralized-council model used successfully elsewhere. Standards should be adopted with local adaptation-taking AAOIFI governance and auditing standards and IFSB principles as the baseline and mapping them onto existing IFRS-based reporting and national audit law rather than building from scratch. Capacity should be built through joint qualification and training partnerships among the central bank, universities, and bodies such as AAOIFI and the Islamic Development Bank, supported by mixed audit teams and “twinning” with established markets to transfer methodology. Proportionality and technology should work together: tiered governance requirements for smaller institutions, shared-service or outsourced internal Islamic finance review for small players, and RegTech and audit-analytics tools that compensate for scarce human capital by automating transaction-level compliance testing. Finally, independence safeguards can be sequenced ahead of a deep talent pool by relying on governance design-functional reporting lines, rotation and cooling-off norms for supervisory-board members, and mandatory disclosure of board composition and remuneration.

Table 3. Emerging-market challenges and proportionate solutions (Central Asian / Uzbek context).

Challenge domain	Manifestation in developing sectors	Proportionate solution
Legal and regulatory	No comprehensive Islamic finance/assurance framework; no compliance-audit mandate; tax and legal frictions (e.g., double transfer tax on Murabaha)	Phased enabling regulation beginning with windows and non-bank Islamic finance; embed a proportionate compliance-audit requirement
Standards and harmonization	Partial or absent AAOIFI/IFSB adoption; unclear fit with IFRS-based reporting and audit law	Adopt AAOIFI/IFSB baseline with local adaptation, mapped onto existing reporting and audit regulation
Governance infrastructure	No national advisory body; fragmented interpretations across institutions	Central-bank-anchored national Islamic finance advisory council to issue and harmonize expert conclusions
Human capital	Shortage of dually-qualified auditors and scholars; thin training base	Joint qualification and training partnerships (central bank, universities, AAOIFI/IsDB); mixed audit teams; twinning
Market scale and technology	Small volumes make full governance costly; weak transaction-level systems	Tiered/proportionate requirements; shared or outsourced internal review; RegTech and audit analytics
Independence safeguards	Few firms and scholars; elevated conflict-of-interest risk	Functional reporting lines; rotation and cooling-off norms; disclosure of composition and remuneration

The framework carries distinct implications for the three constituencies best placed to act on it. These implications follow directly from the dual, interdependent nature of assurance and from the four quality drivers analyzed above.

For central banks. Establish the legal basis for Islamic finance and a national advisory council; mandate proportionate dual-layer assurance; adopt or adapt AAOIFI and IFSB standards; invest in capacity building; and require transparent disclosure of compliance reports and of non-compliant income and its purification. Where Islamic finance is being introduced from a conventional base, these steps are foundational rather than incremental.

For financial regulators and standard-setters. Harmonize compliance-audit methodology and define its interaction with existing financial-audit regulation; set qualification and independence requirements for supervisory boards and internal reviewers; and phase requirements by institution size so that smaller entrants are not deterred while systemic players are held to a higher standard.

For audit practitioners. Build dual competency; adopt mixed-team and combined-assurance models; integrate compliance testing into audit programs; strengthen documentation and escalation; and use analytics to achieve transaction-level coverage that scarce personnel could not otherwise provide.

In conclusion, assurance in Islamic financial institutions is inherently dual, and audit quality must therefore be conceived across both the financial and the compliance layers rather than in the financial layer alone. The three-pillar, governance-anchored framework advanced here integrates the internal Islamic finance audit, the external audit, and the governance boards into a coordinated system founded on internal control; the four drivers explain how quality is produced across the two layers; and proportionate, phased application renders the model feasible in emerging markets such as Uzbekistan. For economies building Islamic finance from a conventional base, credible assurance is not a by-product of growth but a precondition for it. As a conceptual contribution, the framework's propositions await empirical validation, and future research should operationalize and test them as these markets mature.

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