

Ethical Violations in Audit

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Abstract

The study primarily examines the concept of ethics in auditing. For this purpose, the concepts of ethics, ethical principles, and ethical threats are discussed. In this context, ethics are defined through the concepts of honesty, impartiality, professional competence and diligence, confidentiality, and professional conduct, while ethical threats are explained through the concepts of personal interest, self-monitoring, bias, familiarity, and intimidation. The study proposes that the most important precaution against ethical violations is to design an audit process that complies with auditing standards. Therefore, it proposes a client acceptance process that meets the requirements of ethical rules and BDS 200, as well as an audit strategy and planning process. The study includes recommendations for client risk analysis, technical risk analysis, and independence risk analysis, tailored to the scope and purpose.

Key Words: Ethics, auditing, client acceptance procedure

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Introduction

Businesses aim to achieve their primary goal of profitability by conducting their operations within an effective internal control system. In this process, they also serve society through the employment they create.

Sustainability of business operations necessitates effective risk management and, consequently, sound risk analysis. Risk management is, in essence, a decision-making process. The basis for all these decisions, whether financial or non-financial, is the financial statements prepared by businesses and their accompanying explanatory footnotes. Therefore, the financial statement set must be prepared within the framework of the "fair picture principle" and based on fair valuation. The objective criterion for this requirement is accounting standards.

In Turkey, financial reporting standards are published by the Public Oversight Accounting and Auditing Standards Authority (KGK). KGK presents them as TMS/IFRS, BOBI FRS, and KÜMI FRS, depending on the size and legal status of the company. The fundamental assumption in preparing financial statements is the going concern.

Providing reasonable assurance that a set of financial statements is free of material misstatements due to error and/or fraud negatively impacts the decision-making process of financial statement users. This assurance can be achieved through an independent audit.

The reliability of an audited set of financial statements is significantly higher than that of an unaudited set.

At this point, audit quality becomes crucial. A high-quality audit must be planned and conducted in accordance with auditing standards. Furthermore, the auditor must adhere to professional ethical principles. These principles are also determined by the ethical regulations published by the KGK.

In this context, auditors must act within the framework of professional ethical principles such as impartiality, responsibility, honesty, and reliability.

Ethics encompasses all the moral principles that shape individual behavior. It refers to the disciplined attitudes and behaviors that take into account duties and responsibilities. (Kutlu, 2008: 146)

Professional ethics define the rules of conduct that must be adhered to during the practice of a profession, based on the principle of protecting the public good (Daştan, 2009: 284-285;

Kurnaz, Gümüş, 2010: 159). The principles of professional ethics to be applied are explained in the Capital Markets Board (CMB) communiqué as independence, professional skepticism, professional care and diligence, prohibition of commercial and unprofessional activities, prohibition of advertising, obligation of confidentiality, mutual relations, and unfair competition (Akbulut, 1999: 129).

Independent Auditing Standards (ISA 200) outline the general responsibilities of the independent auditor when conducting independent audits of financial statements in accordance with the ISAs. Specifically, the ISAs outline the general objectives of the independent auditor and explain the nature and scope of the audit designed in accordance with these objectives.

Conceptual Framework

Auditors may face ethical threats arising from various external and internal circumstances in the course of their professional activities. These threats may complicate or even completely prevent compliance with fundamental ethical principles.

It is difficult to name each situation that poses a threat to acting in accordance with the fundamental principles and to determine the appropriate action to take in response. Furthermore, the nature of the services provided and the work performed may vary, and therefore, other negative situations may arise that require different measures. Therefore, ethical rules provide a conceptual framework that requires the auditor to identify, analyze, and take appropriate action against threats that prevent them from acting in accordance with the fundamental principles.

The conceptual framework supports auditors in complying with the ethical provisions contained in the specified rules and fulfilling their responsibility to act in the public interest. Furthermore, this approach aims to avoid the logic of "if it's not explicitly prohibited, it's permissible." Auditors should use their professional judgment when assessing the appropriate level of threat and consider whether a knowledgeable third party facing the same situation would reach a similar conclusion (Weil, Hughes, Wagner, 2007).

When determining the nature and severity of a threat, qualitative factors, as well as quantitative ones, should be considered. If the threat cannot be eliminated or mitigated, the auditor may be required to refuse service or withdraw from the engagement. Furthermore, if the auditor discovers a violation of applicable ethical rules, they are obligated to assess the severity of the violation and take the necessary action in a timely manner. If necessary, they should also consider reporting the matter to regulatory authorities. In some unusual circumstances, strict

application of ethical principles may not be in the public interest. In such cases, auditors are encouraged to consult with the relevant regulatory authority (Rule of Ethics for Independent Auditors, 100.7).

Ethical Principles in Auditing

Ethical principles in the auditing profession establish the fundamental standards of conduct to which auditors must adhere in discharging their professional responsibilities. These principles are critical to ensuring audit quality and professional integrity (Code of Ethics for Independent Auditors, 100.1).

Basic Principles

According to BDS 200, the fundamental ethical principles that an auditor must follow during the audit process are clearly stated. Independence plays a critical role, particularly in the evaluation of financial statements, to ensure the reliability and quality of the audit. While legislation and related regulations provide various rules and frameworks for auditors to remain impartial, it is impossible to fully measure this independence. Therefore, auditors are obligated to both maintain their independence and adhere to professional ethical principles (Dabbağoglu, 2018).

Independent auditors must act within ethical standards, particularly in financial reporting processes. In this context, they are expected to comply with the following principles within the scope of ethical rules (KGK, 2023, Article 110.1).

Principle of Honesty

Integrity refers to transparency, trustworthiness, and openness in professional activities. This principle requires the auditor to maintain integrity in all their dealings, provide accurate information in all situations, and demonstrate professional integrity. This principle not only includes refraining from professionally lying, but also from presenting misleading or incomplete information.

If the independent auditor discovers that any document or information is materially inaccurate, misleading, or incomplete, they should not associate themselves with such information or documents and must take the necessary measures to terminate this association (KGK, 2023, Article 110.1). Such situations may also include carelessly prepared statements, untrue statements, or the deliberate concealment of important information.

If the auditor determines that the contents of documents: (a) Contain materially false or misleading statements, (b) Contain carelessly presented statements or information, or (c) Omit or conceal

information that should have been included, and are therefore misleading, they should not be knowingly combined with reports, statements, correspondence, or other information containing such information. If the auditor detects such a situation, they must take the necessary steps to terminate its association with the information in question (Rules of Ethics for Independent Auditors, 110.1).

Principle of Impartiality

The principle of impartiality requires the auditor to avoid any bias, conflict of interest, or external pressure that could alter their professional judgment. This principle prohibits auditors from allowing their personal interests and influences to distort their decision-making processes. While it is difficult to instigate all conflicts of interest, the auditor should refrain from undertaking this service if faced with a situation that could harm the capital (KGK, 2023, Article 120.1).

Principle of Professional Competence and Care

Auditors are expected to keep their technical and professional knowledge current and apply it appropriately while performing their duties. The principle of professional competence and due diligence requires a high level of both knowledge and the quality of practice. Auditors are expected to fulfill the following responsibilities (KGK, 2023, Article 130.1):

- Continuously improve professional competence and apply current knowledge in service delivery,
- Work in accordance with technical standards and professional ethics.

Professional competence is addressed in two fundamental stages. The first is the acquisition of professional competence. The second is the maintenance of this competence throughout the professional career. As stated by TÜRMOB, individuals who have earned this professional title are expected to act in accordance with the professional ethics and behaviors required by this title. The Capital Markets Board (CMB), on the other hand, defines professional competence as achieving independent auditing competence through post-graduate education and work experience.

Confidentiality Policy

The principle of confidentiality requires auditors not to share private information obtained during their professional activities with third parties and not to use this information for personal or other personal gain. This obligation continues not only during the active client relationship but also after its termination (KGK, 2023, Article 140.1).

The auditor must not breach confidentiality in the following situations:

- Sharing information except as required by law,
- Using information for one's own benefit or the benefit of others

However, in some exceptional circumstances, such as those requiring disclosure by law or in situations such as quality control reviews, information sharing is possible within professional ethical boundaries. Considerations for such disclosures include balancing the interests of the parties involved, the verifiability of the information, and the suitability of the recipient.

The Principle of Professional Conduct

Auditors are required to comply with relevant legislation and avoid behavior that could damage their reputation, both for their professional reputation and their public credibility. The principle of professional conduct also imposes a responsibility on auditors to avoid unethical publicity practices, to refrain from making false statements, and to refrain from unfairly criticizing other colleagues (KGK, 2023, Article 150.1).

Particularly in marketing and communication activities, auditors must:

- Avoid unrealistic promises,
- Avoid exaggerating their own experience and services,
- Avoid statements that could harm other professionals.

Threats that may be Encountered during the Audit Process

Various types of threats may arise during the audit process that may make it difficult for the auditor to adhere to fundamental ethical principles. These threats can undermine the auditor's objectivity, integrity, and professional care. One or more situations may constitute a threat, and these threats may affect multiple principles (Code of Ethics for Independent Auditors, 200.1).

Threats

It is stated as follows in the Standard on Ethics for Independent Auditors:

Threats fall into one or more of the following categories:

- Self-interest threat: A self-interest threat occurs when a financial or non-financial interest improperly influences the auditor's judgment or behavior. In such a situation, the auditor may face a conflict of interest while pursuing a professional activity. In addition to posing a threat to impartiality, a conflict of interest may also pose threats to other fundamental principles.

- Self-review threat: The threat that the auditor will not be able to properly evaluate the results of a judgment made by herself or another person in the audit firm she works for, or the result of an activity performed, if she uses these results as a basis for reaching a judgment that is part of the service she performs in the current period.
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- Adoption threat: This is the type of threat that arises when the auditor supports a client's position in a way that compromises his/her own objectivity.
- Familiarity threat: This is the threat that arises when the auditor, due to a long-term or close relationship with a client, shows excessive bias in favor of the interests of that person or shows an excessively accepting approach towards the client's work.
- Threat of intimidation: The threat that the auditor will be prevented from acting impartially due to actual or perceived pressure, including efforts by others to abuse their influence over.

Suggestions on Measures to be Taken Against Threats

A risk-based audit model must be developed to identify and assess the risks posed by the threats described above, take action, and ultimately report the results. The audit process that should be designed and implemented for this purpose is suggested below. In this context:

An audit process encompasses the following phases:

- 1.) Pre-Contract Phase
- 2.) Post-Contract Phase

To effectively establish and execute the pre-contract phase, the following processes must be defined:

- 1.) Customer Risk Analysis
- 2.) Technical Competency Risk Analysis
- 3.) Independence Risk Analysis

If any negative opinion is generated by each analysis, it is unlikely that the auditor will be able to offer services to the prospective client. In this case, if any analysis yields negative results, it is not meaningful to conduct further analyses.

In this context, the identification of the following points can be considered as a minimum requirement in a client risk analysis:

- 1.) Researching shareholders and the board of directors
- 2.) Evaluating the scope of activity and organizational structure
- 3.) Evaluating the senior management profile
- 4.) Evaluating the corporate identity and sectoral situation
- 5.) Conducting intelligence and other research
- 6.) Conducting analytical review
- 7.) Evaluating the continuity status

The determination of the following points can be considered as a minimum requirement in the technical qualification risk analysis:

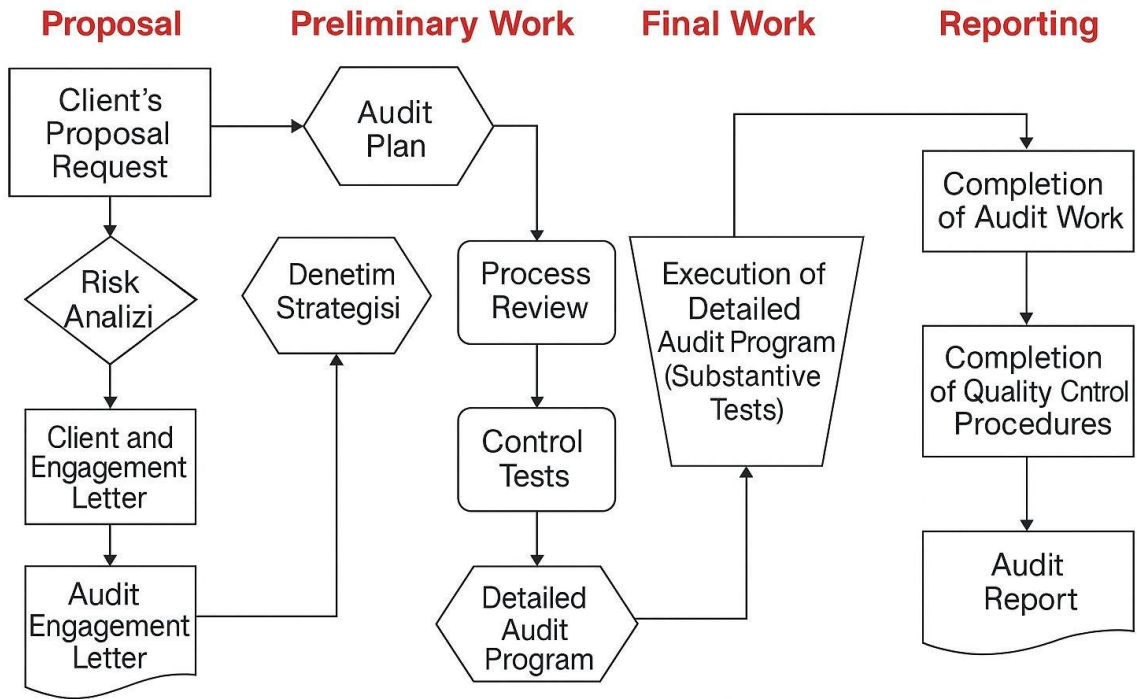
- 1.) Establishing the audit schedule
- 2.) Determining the applicable reporting framework
- 3.) Determining the consolidation status
- 4.) Qualitative and quantitative assessment of the audit team
- 5.) Determining the need for expert support

In an independence risk analysis, determining the following points can be considered as a minimum requirement:

- 1.) Determining the rotation status if the previous period's auditor is the same auditor,
- 2.) Determining the account balance if the previous period's auditor is the same auditor,
- 3.) Obtaining a letter of compliance from the previous period's auditor if the previous period's auditor is a different auditor,
- 4.) Evaluating the projected total hours and unit hourly rate,
- 5.) Evaluating current and past relationships with the prospective client,
- 6.) Evaluating the percentage of service revenue received from the prospective client in total revenue,

The post-contract phase can be effectively designed as described below (Dabbağöğlu, 2018):

AUDIT PROCESS



According to the flow above, the minimum headings that must be included in the audit contract that is at the stage of execution after the client acceptance procedure are as follows (<https://www.kgk.gov.tr/>):

1. In capital companies subject to audit pursuant to the fourth paragraph of Article 397 of the Turkish Commercial Code, the general assembly resolution or court decision forming the basis of the contract must be stated. In companies without a general assembly, the date and number of the decision of the body authorized to appoint the auditor must be stated.
2. The purpose of the audit, the period and scope covered, and any special reasons must be clearly stated.
3. The subject of the audit and the criteria to be used must be clearly and understandably defined.
4. The responsibilities of both parties (the company and the auditor) must be detailed.
5. A clause must be included stating that the audit process will be conducted and concluded in accordance with Turkish Auditing Standards and relevant legal regulations.
6. It must be ensured that all documents, records, and information related to the audit will be available to the auditor without restriction.

7. The names, job titles, estimated working hours, and fees determined for each auditor and their alternates who will serve on the audit team should be listed in detail; the total audit fee should be clearly stated.
8. The responsible auditor and, if applicable, their alternates should be authorized to sign the audit report on behalf of the auditing organization.
9. The start and end dates of the audit, as well as the date the report is due to be submitted, should be clearly stated.
10. A provision stipulating that professional liability insurance will be obtained within the scope of the audit activity should be included.
11. The company must be obligated to inform the auditor of any developments that may occur between the date of the audit report and the publication of the financial statements or activity report and that may affect these documents.
12. The contract must specify that the contract can only be terminated in accordance with relevant legislation.

Following the audit contract, the audit organization develops an audit strategy and plan based on the reporting framework, audit standards, work schedule, work locations, travel schedule, and audit team defined in the contract.

The audit strategy can be defined as conducting direct substantive testing without performing control (compliance) tests, based on the effectiveness of the internal control system evaluation.

The audit plan defines when, by which auditor, and to what extent the following procedures will be performed.

AUDIT PLAN
Information to the Company
Assessment of the Control Environment
Assessment of Risk Monitoring
Assessment of the Information System
Assessment of Monitoring and Surveillance Activities
Assessment of Control Activities
Assessment of Fraud and Irregularity Risk
Software Assessment
Documentation - Special Due Diligence

Continuity Analysis
Determination of Materiality Level
Risks Related to the Financial Statement
Detailed Audit Program - Risk Analysis
Detailed Audit Program - Risks at the Statement Level
Detailed Audit Program - Risks at the Account Level
Detailed Audit Program - Audit Techniques to be Applied

The effective design and execution of the audit strategy and plan outlined above is only possible through the design and implementation of an effective client acceptance procedure. An effective audit strategy and plan will also increase the effectiveness of the detailed audit program (basic testing of accounts), quality control, and reporting processes.

Conclusion

Designing and conducting an audit process in compliance with ethical principles requires the auditor to adhere to the entire set of IASs, particularly IAS 200.

The Independent Auditing Standards categorize the audit process as pre- and post-audit engagements. Therefore, the auditor should design and conduct their own audit process separately according to these two distinct categories. The processes conducted in the pre-engagement phase will form the basis for the design of the post-engagement phase.

Accordingly, the process that should be designed and implemented in the pre-contract phase should consist of the following:

- 1.) Customer risk analysis
- 2.) Technical competence risk analysis
- 3.) Independence risk analysis

The audit process, which will be designed as a whole along with the pre-contract phase, should consist of the following sub-processes after the audit engagement:

- 1.) Audit Strategy
- 2.) Audit Plan
- 3.) Evaluation of the Internal Control System (Review of Processes)
- 4.) Development of detailed audit programs based on the results of the evaluation of the Internal Control System (Definition of substantive accuracy tests)
- 5.) Conducting Field Studies
- 6.) Conducting Quality Control Activities

7.) Preparing and Implementing the Audit Report

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