

Accounting Estimates and Policies

Critical Accounting Estimates

The Notes to our October 31, 2004 consolidated financial statements outline BMO's significant accounting estimates. The accounting estimates discussed below are considered particularly important, as they require significant judgments by management. BMO has established detailed policies and control procedures that are intended to ensure these judgments are well controlled, independently reviewed and consistently applied from period to period. We believe that our estimates for determining the valuation of our assets and liabilities are appropriate.

Allowance for Credit Losses

The allowance for credit losses adjusts the value of credit assets to reflect their estimated realizable value. In assessing their estimated realizable value, we must rely on estimates and exercise judgment regarding matters for which the ultimate outcome is unknown. These include economic factors, developments affecting companies in particular industries and specific issues with respect to single borrowers. Changes in circumstances may cause future assessments of credit risk to be materially different from current assessments, which could require an increase or decrease in the allowance for credit losses.

One of our key balance sheet measures is the provision for credit losses as a percentage of average net loans and acceptances (including securities purchased under resale agreements). Over the past 10 years, the ratio has ranged from a high of 0.66% in 2001 to the current low of (0.07%). This ratio varies based on changes in the economy and credit conditions. Our provision for credit losses would range from a provision of \$1,030 million to a net recovery of \$103 million if we applied these ratios to average net loans and acceptances (including securities purchased under resale agreements) in 2004. Our provision for credit losses recorded for the year ended October 31, 2004 was a net recovery of \$103 million.

Additional information on the process and methodology for determining the allowance for credit losses can be found in the discussion of credit risk on pages 60 and 61 as well as in Note 4 on page 93 of the financial statements.

Financial Instruments Measured at Fair Value

BMO records trading securities as well as trading derivatives at their fair value. Fair value represents our estimate of the proceeds we would receive, or would have to pay in the case of a derivative liability, in a current transaction between willing parties.

BMO's trading securities, derivative assets and derivative liabilities are valued as follows:

	Trading securities	Derivative financial instruments	
		Asset	Liability
Valued using quoted market prices	98%	10%	16%
Valued using internal models*	2%	90%	84%
Total	100%	100%	100%

*Almost all models are based on observable market data.

The fair value of most trading securities and exchange-traded derivatives is based on quoted market prices. Most over-the-counter instruments are valued using models that utilize observable market data. For example, the fair value of interest rate swaps is determined using yield curves developed from observable market interest rates.

Additional information concerning our method of determining fair value is included in Note 3 on page 88, Note 9 on page 97 and Note 26 on page 119 of the financial statements.

Accounting for Securitizations

When loans are securitized, we record a gain or loss on sale. In determining the gain or loss, management must estimate the net present value of expected future cash flows by relying on estimates of the amount of interest and fees that will be collected on the securitized assets, the yield to be paid to investors, the portion of the securitized assets that will be repaid before their scheduled maturity, expected credit losses, the fair value cost of servicing, and the rate at which to discount these estimated future cash flows. Actual cash flows may differ significantly from those estimated by management. If management's estimate of future cash flows were different, our gains on securitization recognized in income would also be different. The rate used to discount expected future cash flows is the estimate that most affects the gain on securitization. A 10% decrease in interest rates would have resulted in a decrease of less than \$10 million in the amount of the deferred purchase price recorded in our Consolidated Balance Sheet.

Additional information concerning accounting for securitizations, including sensitivity analysis for key assumptions, is included in Note 7 on page 95 of the financial statements.

Pensions and Other Employee Future Benefits

Our pensions and other employee future benefits expense is calculated by our actuaries based on assumptions determined by management. If actual experience differs from the assumptions used by management, our pension and other employee future benefits expense could increase or decrease in future years as a result.

The expected rate of return on plan assets is the management estimate that most affects the calculation of pension expense. Our expected rate of return on plan assets is determined based on the plan's target asset allocation and estimated rates of return for each asset class. Estimated rates of return are based on expected returns from fixed income securities, which take into consideration bond yields. An equity risk premium is then applied to estimate equity returns. Returns from other asset classes are set to reflect the relative risks of these classes as compared to fixed income and equity assets. With all other assumptions held constant, a 1% decline in the expected rate of return on assets would result in an increase in pension expense for 2004 of approximately \$31 million. The impact of changes in expected rates of return on plan assets is not significant for our other employee future benefits expense since the amount of assets held in these plans is small.

Pension and other employee future benefits expense and obligations are also sensitive to changes in discount rates. For our Canadian plans, which represent 80% of our pension obligations, we determine our discount rate at each year-end based on market rates on high-quality debt instruments with cash flows that match the timing and amount of expected benefit payments.

As a result of a decrease in long-term interest rates year over year, we changed the discount rate to 6.0% from 6.25% as at October 31, 2004. This change will increase our pension and other employee future benefits expense by approximately \$5 million in 2005.

Additional information regarding our accounting for pensions and other employee future benefits, including sensitivity analysis for key assumptions, is included in Note 20 on page 111 of the financial statements.

Other Than Temporary Impairment

Investment securities that are carried at cost, amortized cost or accounted for using the equity method are reviewed at each quarter-end reporting period to determine whether the fair value is below the current carrying value. When the fair value of any of our investment securities has declined below its carrying value, management is required to assess whether the decline is other than temporary. In making this assessment, we consider such factors as the type of investment, the length of time and extent to which the fair value has been below the carrying value, the financial condition and near-term prospects of the issuer, and our intent and ability to hold the investment long enough to allow for any anticipated recovery. The decision to record a write-down, its amount and the period in which it is recorded could change if management's assessment of the above factors were different. We do not record impairment write-downs on debt securities when impairment is due to changes in interest rates, since we expect to realize the full value of the investments by holding them to maturity. The majority of our investment securities are either issued or guaranteed by Canadian and U.S. governments. For government securities where the carrying value of the investment exceeds fair value, total unrealized losses in 2004 were \$24 million, of which \$7 million relates to securities on which the carrying value exceeded fair value for 12 months or more. In most cases, these unrealized losses resulted from increases in interest rates, not from deterioration in the creditworthiness of the issuer.

We also have investments in corporate debt and equity securities, mortgage-backed securities and collateralized mortgage obligations. Quoted market value is considered to be fair value for actively traded securities. For privately issued securities, and for thinly traded securities where market quotes are not available, we use estimation techniques to determine fair value. Estimation techniques used include discounted cash flows for debt securities, and multiples of earnings or comparisons with other securities that are substantially the same for equity securities. For corporate debt and equity securities, mortgage-backed securities and collateralized mortgage obligations where the carrying value exceeds fair value and an impairment write-down has not been recorded, total unrealized losses in 2004 were \$19 million, of which \$2 million relates to securities on which the carrying value has exceeded fair value for 12 months or more.

Additional information regarding our accounting for investment securities is included in Note 3 on page 88 of the financial statements.

Income Taxes

The provision for income taxes is calculated based on the expected tax treatment of transactions recorded in our Consolidated Statements of Income or Changes in Shareholders' Equity. In determining our provision for income taxes, we interpret tax legislation in a variety of jurisdictions and make assumptions about the expected timing of the reversal of future tax assets and liabilities. If our interpretations differ from those of tax authorities or if the timing of reversals is not as anticipated, our provision for income taxes could increase or decrease in future periods. The amount of any such increase or decrease cannot be reasonably estimated.

Additional information regarding our accounting for income taxes is included in Note 21 on page 114 of the financial statements.

Goodwill

Goodwill is assessed for impairment at least annually. This assessment includes a comparison of the carrying value of each group of businesses having goodwill to the fair value to ensure that the fair value of the group of businesses is greater than its carrying value. If carrying value exceeds fair value for a group of businesses, a more detailed goodwill impairment assessment would have to be undertaken. In determining fair value, we use valuation models such as analysis of discounted cash flows, price-to-earnings ratios and other multiples. Management must exercise judgment and make assumptions in determining fair value. These judgments and assumptions may affect the fair value and any resulting impairment write-down. At October 31, 2004, our estimated fair value of each group of businesses was greater than the carrying value and, as such, the fair value estimate for any of our groups of businesses would have to decline by more than 20% before a detailed impairment assessment would be triggered.

Additional information regarding the composition of BMO's goodwill is included in Note 12 on page 104 of the financial statements.

Changes in Accounting Policies in 2004

At the beginning of fiscal 2004, we made changes in accounting policy in response to new accounting standards. These changes related to our accounting for mortgage prepayment fees, our holdings of our own stock, software development costs and U.S.-dollar-denominated preferred shares. In accordance with

the new standards, we did not restate prior period financial statements to reflect these changes. For fiscal 2004, the total impact of these changes was to increase net income by \$47 million and earnings per share by \$0.09. For further information, see Note 1 on page 87 of the financial statements.

Changes in Accounting Policies in 2005

Variable Interest Entities

We will adopt the Canadian Institute of Chartered Accountants' (CICA) guideline on the consolidation of variable interest entities (VIEs) on November 1, 2004. VIEs include entities where the equity invested is considered insufficient to finance the entity's activities. Under this new guideline, we will be required to consolidate VIEs if the investments we hold in these entities and/or the relationships we have with them result in us being exposed to a majority of their expected losses, being able to benefit from a majority of their expected residual returns, or both, based on a calculation outlined by the standard setters.

Under the new rules, we will be required to consolidate our customer securitization vehicles. These VIEs are set up to assist our customers with the securitization of their assets in order to provide them with an alternate source of funding. The impact of consolidating these VIEs will be an increase in assets of \$20,807 million, an increase in liabilities of \$20,848 million and a decrease in opening retained earnings of \$41 million. The impact on net income in future periods is not expected to be significant. When we adopt the new rules, we will not restate prior period financial statements.

Our assets-to-capital multiple, a measure of capital adequacy, will increase as a result of the consolidation of these VIEs. Our regulator, the Office of the Superintendent of Financial Institutions (OSFI), has provided capital relief for those assets for the first two quarters of fiscal 2005. If capital relief is not extended beyond the second quarter, we may restructure these vehicles.

Liabilities and Equity

We will adopt the CICA's new accounting requirements on the classification of financial instruments as liabilities or equity on November 1, 2004. The new rules require that our preferred shares and capital trust securities that are ultimately convertible into a variable number of our common shares at the holders' option be classified as liabilities. Under the new rules, \$1,150 million of our capital trust securities currently recorded as non-controlling interest in subsidiaries will be classified as debt in our Consolidated Balance Sheet. The return paid to capital trust securities holders will be recorded as interest expense rather than as non-controlling interest in subsidiaries in our Consolidated Statement of Income. Under the new rules, we will also reclassify \$450 million of our Class B Preferred shares, Series 4 and 6, as debt. As a result, dividends on these shares will be recorded as interest expense.

The adoption of these new rules is expected to increase interest expense by approximately \$100 million, decrease non-controlling interest in subsidiaries by approximately \$40 million and decrease income taxes by approximately \$35 million, resulting in an overall decrease in net income of approximately \$25 million for the year ended October 31, 2005. This change will not have any impact on earnings per share or net income available to common shareholders in future or prior periods, since preferred share dividends are currently deducted from net income in determining these measures.

When we adopt the new rules, we will restate our consolidated financial statements to reflect the change in prior periods. The impact of restating prior periods will be an increase in interest expense of between \$122 million and \$128 million, a decrease in non-controlling interest in subsidiaries of \$41 million, a decrease in income taxes of \$37 million and a decrease in net income of between \$44 million and \$50 million in each of fiscal 2002, 2003 and 2004.

Our regulator, OSFI, will continue to consider all of our reclassified instruments to be Tier 1 capital. Our Series D Capital Trust Securities issued in September 2004 will continue to be recorded as non-controlling interest in subsidiaries and our other Class B Preferred shares, Series 5 and 10, will continue to be classified as equity under the new rules. New capital instruments issued in the future are expected to have terms consistent with presentation as equity.

Investment Companies

We will adopt the CICA's new accounting requirements for merchant banking subsidiaries beginning on November 1, 2004. These subsidiaries currently account for their investments at cost. Under the new rules, these investments will be accounted for at fair value, with the initial adjustment to fair value and subsequent changes recorded in net income. The ultimate impact of this change depends on future changes in fair value and cannot be determined at this time. The carrying amount of investments subject to this accounting change was approximately \$550 million as at October 31, 2004.