

Critical Accounting Estimates

The Notes to BMO's October 31, 2005 consolidated financial statements outline our significant accounting estimates. The accounting estimates discussed below are considered particularly important, as they require significant judgments by management. Management 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 BMO's 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 performance measures is the provision for credit losses as a percentage of average net loans and acceptances (including securities borrowed or purchased under resale agreements). Over the past 10 years, the ratio has ranged from a high of 0.66% in 2001 to a low of (0.07%) in 2004. This ratio varies with changes in the economy and credit conditions. If we applied these high and low ratios to average net loans and acceptances (including securities borrowed or purchased under resale agreements) in 2005, our provision for credit losses would range from a provision of \$1,119 million to a net recovery of \$119 million. Our provision for credit losses in 2005 was \$179 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 page 69 as well as in Note 4 on page 100 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.

The extent of our use of quoted market prices and internal models in the valuation of trading securities, derivative assets and derivative liabilities at October 31, 2005 was as follows:

	Trading securities	Derivative financial instruments	
		Asset	Liability
Valued using quoted market prices	99%	11%	13%
Valued using internal models*	1	89	87
Total	100%	100%	100%

*Almost all models are based on observable market data.

The fair values of most trading securities and exchange-traded derivatives are determined from quoted market prices. Most over-the-counter derivatives 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.

Valuation models use general assumptions and market data and therefore do not reflect the specific risks and other factors that would affect a particular instrument's fair value. As a result, we incorporate certain adjustments when using internal models to establish fair values. These fair value adjustments take into account the estimated impact of credit risk, liquidity risk, valuation considerations, administrative costs and closeout costs. For example, the credit risk adjustment incorporates credit risk into our determination of fair values by taking into account factors such as the counterparty's credit rating, the duration of the instrument and changes in credit spreads.

A group independent of the trading lines of business, Valuation Product Control (VPC), verifies the fair values at which instruments are recorded. For instruments that are valued using models, VPC identifies situations where adjustments must be made to the model estimates to arrive at fair value.

The methodologies used for calculating these adjustments are reviewed at least annually to ensure that they remain appropriate. Significant changes in methodologies are rare and are made only when we feel that the change will result in better estimates of fair value.

Valuation Adjustments

As at October 31 (\$ millions)	2005	2004
Credit risk	63	39
Liquidity risk	19	11
Administrative costs	17	17
Other	5	10
	104	77

There were no significant changes in methodologies for calculating the fair value adjustments during 2005 and 2004. The increase in the adjustment for credit risk was due to the 26% increase in the fair value of derivative assets relative to 2004 as well as increased credit spreads. The increase in the adjustment for liquidity risk was due primarily to some unusually long-dated instruments.

Additional information concerning our method of determining fair value is included in Note 3 on page 97, Note 9 on page 106 and Note 29 on page 130 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 \$14 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 103 of the financial statements.

Pensions and Other Employee Future Benefits

BMO's pensions and other employee future benefits expense is calculated by our actuaries using assumptions determined by management. If actual experience differs from the assumptions used, pension and other employee future benefits expense could increase or decrease in future years. 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 using 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 expected equity returns. Expected returns from other asset classes are established to reflect the risks of these asset classes relative to fixed income and equity assets. With all other assumptions held constant, a 1 percentage point decline in the expected rate of return on plan assets would result in an increase in pension expense for 2005 of approximately \$33 million. The impact of changes in expected rates of return on plan assets is not significant for our other employee future benefits expense since there is only a small amount of assets held in these plans.

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 BMO's pension obligations, we determine a discount rate at each year-end using market rates applicable to high-quality debt instruments with cash flows that match the timing and amount of expected benefit payments.

Additional information regarding our accounting for pensions and other employee future benefits, including sensitivity analysis for key assumptions, is included in Note 22 on page 121 of the financial statements.

Other Than Temporary Impairment

Investment securities that are carried at cost or 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 those 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. Most of BMO's investment securities are issued or guaranteed by Canadian or U.S. governments. At the end of 2005, there were total unrealized losses of \$37 million on government securities for which the carrying value of the investment exceeded fair value. Of this amount, \$7 million related to securities for which the carrying value had 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 securities where market quotes are not available, we use estimation techniques to determine fair value. These techniques include discounted cash flows for debt securities and, for equity securities, multiples of earnings or comparisons with other securities with similar characteristics. At the end of 2005, there were total unrealized losses of \$18 million on corporate debt and equity securities, mortgage-backed securities and collateralized mortgage obligations for which the carrying value exceeded fair value and an impairment write-down had not been recorded. Of this amount, \$1 million related to securities for which the carrying value had exceeded fair value for 12 months or more.

Additional information regarding our accounting for investment securities is included in Note 3 on page 97 of the financial statements.

Customer Loyalty Program

We record the liability related to our credit card customer loyalty program when our customers become entitled to redeem the rewards. In determining the liability, we estimate the expected future redemption rate and apply the cost of expected redemptions. Our estimate of the expected redemption rate is based on a statistical analysis of past customer behaviour. Changes in actual future redemption rates may cause future assessments of the liability to be different from the current assessment, resulting in an increase or decrease in the liability. Changes in redemption rates can result from factors such as shifts in customer behaviour, types of rewards offered and general economic conditions. If our estimate of the future redemption rate increased by 5 percentage points, the annual impact on our card fee revenue would be a decrease of approximately \$10 million.

Additional information regarding our accounting for our customer loyalty program is included in Note 16 on page 115 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 the 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 23 on page 124 of the financial statements.

Goodwill

Goodwill is assessed for impairment at least annually. This assessment includes a comparison of the carrying value and

fair value of each group of businesses having goodwill to ensure that the fair value of the group is greater than its carrying value. If the carrying value exceeds the fair value of the group, 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, and different judgments and assumptions could affect the determination of fair value and any resulting impairment write-down. At October 31, 2005, the estimated fair value of each of our groups of businesses was greater than the carrying value and 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 13 on page 113 of the financial statements.

Changes in Accounting Policies in 2005

Variable Interest Entities

We adopted the Canadian Institute of Chartered Accountants' (CICA's) 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 guideline, we consolidate VIEs if the investments we hold in these entities or the relationships we have with them result in us being exposed to a majority of their expected losses or being able to benefit from a majority of their expected residual returns, based on a calculation outlined by the standard setters.

Under the new rules, we consolidated our customer securitization vehicles from November 1, 2004 to April 29, 2005. 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. As at April 29, 2005, we restructured our interest in the VIEs and were no longer required to consolidate the VIEs. The impact of consolidating the VIEs was a \$37 million increase in net income, representing the reversal of the unamortized mark-to-market losses on hedging derivatives held by the VIEs. Additional information on these VIEs can be found in Note 8 on page 105 of the financial statements.

Liabilities and Equity

We adopted 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 preferred shares and capital trust securities that are ultimately convertible into a variable number of common shares at the holders' option be classified as liabilities. Under the new rules, \$1,150 million of our capital trust securities were reclassified from non-controlling interest in subsidiaries to debt in our Consolidated Balance Sheet. The return paid to capital trust securities holders is recorded as interest expense rather than as non-controlling interest in subsidiaries in our Consolidated Statement of Income. Under the new rules, we also reclassified \$450 million of our Class B Preferred shares, Series 4 and 6, as debt. As a result, dividends on these shares are recorded as interest expense. Prior periods were restated to reflect the change in classification. Our regulator, OSFI, continues to consider all of our reclassified instruments to be Tier 1 capital. Additional information regarding the accounting change is included in Note 20 on page 119 of the financial statements.

Merchant Banking Investments

We adopted the CICA's new accounting requirements for merchant banking subsidiaries on November 1, 2004. These subsidiaries now account for their investments at fair value, with changes in fair value recorded in net income. Previously, they accounted for their investments at cost. The change in accounting increased investment securities gains by \$50 million in our Consolidated Statement of Income, including the initial adjustment to fair value upon adoption. Prior periods were not restated. Additional information regarding the accounting change is included in Note 3 on page 98 of the financial statements.

Future Changes in Accounting Policies

Financial Instruments and Comprehensive Income

The CICA has issued new accounting rules on financial instruments, hedges and comprehensive income that will require BMO to account for most of our investment securities and all of our derivative financial instruments at fair value. When we adopt the new rules on November 1, 2006, we will remeasure certain investment securities and certain derivative financial instruments at fair value, and report a new section of shareholders' equity called comprehensive income. The impact of recording these assets and liabilities at fair value will be recognized in opening equity and results for prior periods will not be restated. We cannot currently determine the impact that these rules will have on our consolidated financial statements, as this will be dependent on the fair values of those financial instruments in the future.

Earnings per Share

The CICA has issued new rules that will require BMO to include the potential conversion of certain of our preferred shares and capital trust securities to common shares in the calculation of diluted earnings per share. The effective date has not been finalized; however, we expect to adopt these new rules in the year ended October 31, 2006. Diluted earnings per share of prior periods will be restated upon adoption. Under the new standard, our diluted earnings per share for the years ended October 31, 2005, 2004 and 2003 would be reduced by approximately \$0.06, \$0.09 and \$0.11, respectively.

Disclosure Controls and Procedures and Internal Controls over Financial Reporting

Disclosure controls and procedures are designed to provide reasonable assurance that all relevant information is gathered and reported to senior management, including the CEO and CFO, on a timely basis so that appropriate decisions can be made regarding public disclosure.

An evaluation of the effectiveness of the design and operation of our disclosure controls and procedures was conducted as of October 31, 2005, by and under the supervision of Bank of Montreal's management, including the CEO and CFO. Based on this evaluation, the CEO and CFO have concluded that our disclosure controls and procedures, as defined in Multilateral Instrument 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings, and in Rule 13a-15(e) under the *Securities Exchange Act of 1934* (the Exchange Act), are effective to ensure that information required to be disclosed in reports that we file or submit under Canadian securities legislation and the Exchange Act is recorded, processed, summarized and reported within the time periods specified in those rules and forms.

Internal controls over financial reporting are designed to provide reasonable assurance regarding the reliability of our financial reporting and compliance with Canadian generally accepted accounting principles in our financial statements.

Bank of Montreal's management has evaluated whether there were changes in our internal controls over financial reporting during the year ended October 31, 2005 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting. No such changes were identified through management's evaluation or any other means.

For the year ending October 31, 2006, we expect to comply with Section 404 of the *Sarbanes-Oxley Act*, which requires that we issue a report on management's assessment of the effectiveness of our internal controls over financial reporting and that management's assessment be independently audited by the shareholders' auditors.