

Critical Accounting Estimates

The Notes to BMO's October 31, 2006 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 of the value 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 2006, our provision for credit losses would range from a provision of \$1,226 million to a net recovery of \$130 million. Our provision for credit losses in 2006 was \$176 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 68 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, 2006 was as follows:

	Trading securities	Derivative financial instruments	
		Asset	Liability
Valued using quoted market prices	99%	24%	23%
Valued using internal models*	1	76	77
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)	2006	2005
Credit risk	33	63
Liquidity risk	42	19
Administrative costs	7	17
Other	9	5
	91	104

There were no significant changes in methodologies for calculating the fair value adjustments during 2006 and 2005. The decrease in the adjustment for credit risk was due to decreased credit spreads and reduced counterparty risk. The increase in the adjustment for liquidity risk was due primarily to the higher volume of commodity options in 2006 compared to 2005. In 2006, refinements were made to the calculation of the administrative costs adjustment to reflect the more precise information that is available.

Additional information concerning our method of determining fair value is included in Note 3 on page 98, Note 9 on page 107 and Note 28 on page 129 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, 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 interest 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 \$20 million in the amount of the deferred purchase price recorded in investment securities 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.

Accounting for Variable Interest Entities

In the normal course of business, BMO enters into arrangements with variable interest entities (VIEs). VIEs include entities with equity that is considered insufficient to finance the entity's activities or in which the equity holders do not have a controlling financial interest. We are 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 the majority of their expected losses, being able to benefit from a majority of their expected residual returns, or both, based on a calculation determined by standard setters.

We use a qualitative estimation process to determine whether an entity is a VIE. We also use a variety of complex estimation processes involving qualitative and quantitative factors to calculate and analyze a VIE's expected losses and its expected residual returns. These processes involve estimating the future cash flows and performance of the VIE, analyzing the variability of those cash flows and allocating the losses and returns among the identified parties holding variable interests. These processes enable us to identify the party that is exposed to the majority of the VIE's expected losses, expected residual returns, or both, and thus who should consolidate the entity.

Additional information concerning BMO's involvement with variable interest entities is included in Note 8 on page 105 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 that 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 2006 of approximately \$37 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 carrying value. When the fair value of any of our investment securities declines 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 2006, there were total unrealized losses of \$44 million on government securities for which the carrying value of the investment exceeded fair value. Of this amount, \$21 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, internal models that utilize observable market data or comparisons with other securities with similar characteristics. At the end of 2006, there were total unrealized losses of \$13 million on corporate debt and equity securities, mortgage-backed securities and collateralized mortgage obligations on which the carrying value exceeded fair value and an impairment write-down had not been recorded. Of this amount, \$12 million related to securities on 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, our annual card fee revenue would decrease by approximately \$11 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 that use 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, 2006, the estimated fair value of each of our groups of businesses was significantly greater than its carrying value. In fact, the estimated fair value of any of our groups of businesses would have to decline by more than 30% 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.

Contingent Liabilities

BMO and its subsidiaries are involved in various legal actions in the ordinary course of business. Management does not expect the outcome of any of these proceedings to have a material adverse effect on BMO's consolidated financial position or results of operations.

Contingent litigation loss provisions are recorded when it becomes likely that BMO will incur a loss and the amount can be reasonably estimated. BMO's management and internal and external experts are involved in assessing any likelihood and in estimating any amounts involved. The actual costs of resolving these claims may be substantially higher or lower than the amounts provided. Additional information regarding contingent liabilities is included in Note 27 on page 128 of the financial statements.

Changes in Accounting Policies in 2006**Stock-Based Compensation**

During the year ended October 31, 2006, we adopted the Canadian Institute of Chartered Accountants' (CICA) new accounting requirements on stock-based compensation. The new rules require that stock-based compensation granted to employees eligible to retire should be expensed at the time of grant. Previously, we amortized the cost over the vesting period. Financial statements for prior years were restated to reflect the change in accounting policy. Results and balances for years prior to 2004 reflected in or used in calculations in MD&A schedules were not restated as the amounts related to any particular year are relatively insignificant. The new rules resulted in decreases in net income of \$2 million, \$4 million and \$11 million in our Consolidated Statements of Income for the years ended October 31, 2006, 2005 and 2004, respectively. Additional information regarding

this accounting change is included in Note 21 on page 120 of the financial statements.

Settlement Date Accounting

During the year ended October 31, 2006, we changed our accounting policy for securities transactions from the trade date basis of accounting to the settlement date basis of accounting for the Consolidated Balance Sheet. As a result, at October 31, 2006 there was a decrease of \$1,896 million in trading securities, \$6,618 million in other assets and \$8,514 million in other liabilities in our Consolidated Balance Sheet. Prior periods were restated to reflect the change in accounting policy. Additional information regarding this 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 us to account for all of our investment securities and hedging derivatives at fair value. When we adopt the new rules on November 1, 2006, we will remeasure our securities and derivatives, as appropriate, at fair value and report a new section of shareholders' equity called other comprehensive income.

The impact of remeasuring our hedging derivatives at fair value on November 1, 2006 will be recognized in opening retained earnings and opening other comprehensive income, as appropriate. We are determining the impact that these changes

in accounting policy will have on our consolidated financial statements once adopted, based on recently released transitional guidance. The impact of reclassifying investment securities as available-for-sale securities and remeasuring them at fair value on November 1, 2006 will be recognized in opening accumulated other comprehensive income. The impact on our Consolidated Balance Sheet at November 1, 2006 will be an increase in available-for-sale securities of approximately \$55 million and an increase in accumulated other comprehensive income of approximately \$36 million, net of tax. Prior periods will not be restated.

Management's Annual Report on Disclosure Controls and Procedures and Internal Control over Financial Reporting

Disclosure Controls and Procedures

Disclosure controls and procedures are designed to provide reasonable assurance that all relevant information is gathered and reported to senior management, including the President & Chief Executive Officer (CEO) and the Chief Financial & Administrative Officer (CFAO), 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, 2006, by and under the supervision of BMO Financial Group's management, including the CEO and the CFAO. Based on this evaluation, the CEO and the CFAO have concluded that our disclosure controls and procedures, as defined in Canada by Multilateral Instrument 52-109, Certification of Disclosure in Issuers' Annual and Interim Filings, and in the United States by 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 Control over Financial Reporting

Internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial

reporting and the preparation of financial statements in accordance with Canadian generally accepted accounting principles and the requirements of the Securities and Exchange Commission in the United States, as applicable. Management is responsible for establishing and maintaining adequate internal control over financial reporting for BMO Financial Group.

BMO Financial Group's management, including the CEO and the CFAO, has evaluated the effectiveness of our internal control over financial reporting using the framework and criteria established in *Internal Control – Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management has concluded that internal control over financial reporting was effective as of October 31, 2006.

BMO Financial Group's auditor, KPMG LLP (Shareholders' Auditor), an independent registered public accounting firm, has issued an audit report on our management's assessment of our internal control over financial reporting. This audit report appears on page 91.

Changes in Internal Control over Financial Reporting

There were no changes in internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Shareholders' Auditor Pre-Approval Policy and Fees

Pre-approval Policies and Procedures

As part of BMO Financial Group's corporate governance practices, the Board continues to ensure that a strict policy is in place limiting the Shareholders' Auditor from providing services not related to their role as auditor. All services provided by the Shareholders' Auditor are pre-approved by the Audit Committee as they arise, or through an annual pre-approval of amounts for specific types of services. All services comply with our Auditor Independence Policy, as well as professional standards and securities regulations governing auditor independence.

Shareholders' Auditor's Service Fees

Aggregate fees paid to the Shareholders' Auditor during the fiscal years ended October 31, 2006 and 2005 were as follows:

Fees (\$ millions) (1)	2006	2005
Audit fees	10.7	7.8
Audit-related fees (2)	0.1	0.2
Tax fees	–	–
All other fees (3)	0.5	1.6
Total	11.3	9.6

(1) The classification of fees is based on United States Securities and Exchange Commission definitions and applicable Canadian securities laws.

(2) Audit-related fees for 2006 and 2005 relate to fees paid for accounting advice, specified procedures on our Proxy Circular and translation services.

(3) All other fees for 2006 relate to fees paid for reviews of compliance with regulatory requirements for financial information, reports on internal controls over services provided by various BMO Financial Group businesses and corporate recovery services that were grandfathered when the Bank's Auditor Independence Policy came into effect. All other fees for 2005 relate to the same services provided in 2006 as well as fees paid for assistance with documentation of internal control over financial reporting under Section 404 of the *Sarbanes-Oxley Act*. These documentation services were provided under the direct supervision of BMO management.