rate sensitivities can be found in the Enterprise-Wide Risk Management section on pages 65 to 73 of this MD&A.

Further information on how we determine the fair value of financial instruments is included in the Financial Instruments Measured at Fair Value discussion in the Critical Accounting Estimates section of the MD&A that follows.

Critical Accounting Estimates

The Notes to BMO's October 31, 2007 Consolidated Financial Statements outline our significant accounting estimates. The following accounting estimates 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 2007, our provision for credit losses would range from a provision of $1,346 million to a net recovery of $143 million. Our provision for credit losses in 2007 was $353 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 67 as well as in Note 4 on page 101 of the financial statements.

Financial Instruments Measured at Fair Value

BMO records securities and 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.

We use a fair value hierarchy to categorize the inputs we use in valuation techniques to measure fair value. The extent of our use of quoted market prices (Level 1), internal models using observable market information as inputs (Level 2) and internal models without observable market information (Level 3) in the valuation of securities, derivative assets and derivative liabilities at October 31, 2007 was as follows:

	Available-for-sale securities	Trading securities	Derivative instruments	
			Asset	Liability
Valued using quoted market prices	59%	93%	8%	8%
Valued using internal models (with observable inputs)	35	–	91	91
Valued using internal models (without observable inputs)	6	7	1	1
Total	100%	100%	100%	100%

The fair values of most securities and exchange-traded derivatives are determined on a Level 1 basis, from quoted market prices. The majority of over-the-counter derivatives are valued using multi-contributor prices or models that utilize observable market data (Level 2). For example, the fair value of interest rate swaps is determined using yield curves developed from observable market interest rates. A small percentage of over-the-counter derivatives and securities are valued based upon inputs that are not observable or cannot be corroborated by market data (Level 3). For example, the fair value of a long-dated cross-currency swap may be determined using forward curve assumptions that can only be extrapolated from available market information. See page 68 for Market Risk discussion. Included in Level 3 for trading securities is the asset-backed commercial paper issued by non-bank-sponsored conduits and one BMO-sponsored conduit. Included in Level 3 for available-for-sale securities is our investment in the capital notes and senior notes of our BMO-sponsored SIVs. We determined the fair value of these securities using a variety of valuation techniques, including discounted cash flows, fair value of the underlying assets and proxy securities.

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 financial 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. During the year, we changed our valuation process to incorporate a more appropriate market-based valuation methodology for the commodities portfolio.

The methodologies used for calculating these adjustments are reviewed on an ongoing basis 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)	**2007**	2006
Credit risk	**50**	33
Liquidity risk	**20**	42
Administrative costs	**7**	7
Other	**2**	9
	79	91

The increase in the adjustment for credit risk was due to wider credit spreads and refinements to the calculation to reflect more market-based inputs. The reduction in the valuation adjustment for liquidity risk was primarily due to lower holdings of commodities derivatives.

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 gain 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 $32 million in the amount of the deferred purchase price recorded in available-for-sale 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 104 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 and whether BMO holds a variable interest in that 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 which party should consolidate the entity.

Additional information concerning BMO's involvement with variable interest entities is included in Note 8 on page 106 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 2007 of approximately $41 million. The impact of changes in expected rates of return on plan assets is not significant for our other employee future benefits expense since only small amounts of assets are 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 currently represent 86% 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 23 on page 125 of the financial statements.

Other Than Temporary Impairment

We review available-for-sale and other securities at each quarter-end reporting period to identify and evaluate investments that show indications of possible impairment. An investment is considered impaired if its unrealized losses represent impairment that is considered to be 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 cost, 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 market interest rates, since we expect to realize the full value of these investments by holding them to maturity.

We also have investments in securities issued or guaranteed by Canadian or U.S. governments, 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. At the end of 2007, there were total unrealized losses of $48 million on securities on which the cost exceeded fair value and an impairment write-down had not been recorded. Of this amount, $14 million related to securities on which the cost had exceeded fair value for 12 months or more. In most cases, these unrealized losses resulted from increases in market interest rates and not from deterioration in the creditworthiness of the issuer.

Additional information regarding our accounting for available-for-sale securities and other securities is included in Note 3 on page 97 of the financial statements. Additional information concerning our method of determining fair value is included in Note 3 on page 98, Note 9 on page 110 and Note 29 on page 133 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. We pay the loyalty program administrator when air miles are redeemed. In determining the liability, we estimate the expected future redemption rate and apply the cost of expected redemptions. Our estimate of the expected future redemption rate is based on a statistical analysis of past customer behaviour. Changes in actual 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 redemption rate increased by 1 percentage point, our annual card fee revenue would decrease by approximately $12 million. During fiscal 2007, we increased the liability related to future customer redemptions by $185 million ($120 million after-tax).

Additional information regarding our accounting for our customer loyalty program is included in Note 16 on page 117 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 24 on page 128 of the financial statements.

Goodwill and Intangible Assets

Goodwill is assessed for impairment at least annually. This assessment includes a comparison of the carrying value and the fair value of each group of businesses 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, 2007, 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.

Intangible assets are amortized to income on either a straight-line or an accelerated basis over a period not exceeding 15 years, depending upon the nature of the asset. There are no intangible assets with indefinite lives. We test intangible assets for impairment when circumstances indicate the carrying value may not be recoverable. No such impairment has been identified for the years ended October 31, 2007, 2006 and 2005.

Additional information regarding the composition of goodwill and intangible assets is included in Note 13 on page 115 of the financial statements.

Contingent Liabilities

BMO and its subsidiaries are involved in various legal actions in the ordinary course of business.

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 28 on page 132 of the financial statements.

Changes in Accounting Policies in 2007

Financial Instruments, Hedges and Comprehensive Income

On November 1, 2006, we adopted the CICA's new accounting requirements for securities, hedging derivatives and certain other financial instruments. Under these new rules, we are required to measure certain securities and hedging derivatives at fair value and include a new section in Shareholders' Equity, called Accumulated Other Comprehensive Income (Loss), to report unrealized gains or losses related to certain available-for-sale securities and cash flow hedges and foreign exchange gains or losses on our net investment in foreign operations.

Certain of our available-for-sale securities (previously referred to as investment securities) are recorded at fair value under the new rules. Unrealized gains or losses are deferred in Accumulated Other Comprehensive Income (Loss) until the securities are sold or there is impairment that is to be considered other than temporary. It is only at that time that any gain or loss is recorded in net income. Securities whose sale is restricted, or that are not traded in an active market, are also included in available-for-sale securities, but continue to be recorded at cost. The new rules do not affect accounting for our merchant banking investments or investments in corporate equity where we exercise significant influence, but not control.

All of our hedging derivatives are recorded at fair value under the new rules, but changes in fair value only impact net income to the extent that they do not perfectly offset changes in the fair value of the item that we are hedging (hedge ineffectiveness). Any hedge ineffectiveness is recorded in net income. Our hedging programs are such that hedging derivatives should very closely match the items that they hedge and, as a result, we do not expect a significant amount of hedge ineffectiveness to arise.

Unrealized gains and losses on equity securities included in Accumulated Other Comprehensive Income (Loss) are now included in our Tier 1 and Total Capital Ratios. The impact was insignificant at October 31, 2007. Foreign exchange gains or losses related to the translation of our net investment in foreign operations, which were also reported in Shareholders' Equity in prior periods, continue to be included in the determination of our capital ratios.

Total Accumulated Other Comprehensive Income (Loss) is included in Shareholders' Equity for purposes of calculating return on equity, which resulted in an insignificant increase in the return for 2007.

For details of the specific accounting changes and related impacts, refer to Notes 1, 3, 4, 9 and 15 to the financial statements.

Future Changes in Accounting Policies

Financial Instruments – Disclosure and Presentation

Effective for the fiscal year ending October 31, 2008, BMO will adopt the CICA's new handbook requirements regarding the disclosure and presentation of financial instruments. The new requirements are intended to enhance financial statement users' ability to evaluate the significance of financial instruments to an enterprise and the exposures inherent within these instruments, and to understand the entity's ongoing management of such exposures.

Capital Disclosures

Consistent with enhancing disclosures on risk and management of risk, BMO will adopt the CICA's new handbook section establishing requirements to disclose both qualitative and quantitative information on capital management. This disclosure requirement is intended to enhance a reader's evaluation of an entity's objectives, policies and procedures related to ongoing capital management.

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 Executive Vice-President Finance and Treasurer and Acting Chief Financial Officer (Acting 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, 2007, by and under the supervision of BMO Financial Group's management, including the CEO and the Acting CFO. Based on this evaluation, the CEO and the Acting CFO have concluded that, as of October 31, 2007, 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 therein.

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's internal control over financial reporting includes policies and procedures that: pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of BMO; provide reasonable assurance that transactions are recorded as necessary to permit preparation of the 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, and that receipts and expenditures of BMO are being made only in accordance with authorizations of management and directors of BMO; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of BMO's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting can provide only reasonable assurance and may not prevent or detect misstatements. Further, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

BMO Financial Group's management, including the CEO and the Acting CFO, 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, 2007.

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

Changes in Internal Control over Financial Reporting

In connection with BMO Financial Group's review of its losses in its commodities trading business, BMO determined at the end of the second quarter of 2007 that a more appropriate market-based methodology should be used for valuing the commodities portfolio and that the independent price verification processes previously performed by BMO failed to identify price discrepancies. These factors, together with increased concerns with the reliability of quotes from BMO's principal broker used in the first quarter valuation, resulted in the restatement of BMO's previously reported financial statements for the quarter ended January 31, 2007.

In light of the foregoing, BMO made the following changes in the second, third and fourth quarters:

- placed two of our commodities professionals on leave. Those individuals are no longer employed by BMO;
- changed reporting lines within BMO Capital Markets for the commodities business, appointed a new head of energy trading and hired additional key personnel;
- suspended our business relationship with the principal broker used in the first quarter valuation;
- changed our independent price verification process to incorporate a more appropriate market-based valuation methodology for determining ongoing mark-to-market valuation of the commodities portfolio; and
- increased management oversight, implemented new risk limits and reduced existing risk limits.

Except for the above changes, there were no changes in our internal control over financial reporting in fiscal 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Pre-Approval of Shareholders' Auditors' Services and Fees

Pre-approval Policies and Procedures

As part of BMO Financial Group's corporate governance practices, the Board ensures the strict application of BMO's corporate policy limiting the services provided by the Shareholders' Auditors that are not related to their role as auditors. All services provided by the Shareholders' Auditors 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' Auditors' Fees

Aggregate fees paid to the Shareholders' Auditors during the fiscal years ended October 31, 2007 and 2006 were as follows:

Fees ($ millions) (1)	**2007**	2006
Audit fees	**12.0**	10.7
Audit-related fees (2)	**0.1**	0.1
Tax fees	**–**	–
All other fees (3)	**0.1**	0.5
Total	**12.2**	11.3

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

(2) Audit-related fees for 2007 relate to fees paid for accounting advice and specified procedures on our Proxy Circular. Audit-related fees for 2006 relate to the same services provided in 2007 as well as fees paid for translation services.

(3) All other fees for 2007 and 2006 relate to fees paid for reviews of compliance with regulatory requirements for financial information and reports on internal controls over services provided by various BMO Financial Group businesses. Also included in 2006 are corporate recovery services that were grandfathered when BMO's Auditor Independence Policy came into effect.