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## W.W. Grainger, Inc. and Subsidiaries

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005 and 2004

#### NOTE 1 – BACKGROUND AND BASIS OF PRESENTATION

##### INDUSTRY INFORMATION

W.W. Grainger, Inc. is the leading broad-line supplier of facilities maintenance and other related products in North America. In this report, the words “Company” or “Grainger” mean W.W. Grainger, Inc. and its subsidiaries.

##### MANAGEMENT ESTIMATES

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent liabilities, and revenues and expenses. Actual results could differ from those estimates.

##### RECLASSIFICATIONS

Certain amounts in the 2005 and 2004 financial statements, as previously reported, have been reclassified to conform to the presentation adopted in 2006. The Company reclassified certain employment-related benefits on its consolidated balance sheets in 2005 and 2004 which were previously presented as current liabilities to noncurrent liabilities. The amounts reclassified totalled \$31.6 million and \$26.4 million in 2005 and 2004, respectively. The Company also reclassified the related current deferred income tax assets to noncurrent deferred income tax assets. The amounts reclassified totalled \$12.3 million and \$10.3 million in 2005 and 2004, respectively. The reclassifications did not change consolidated net income or net cash flows from operations for the years presented.

##### PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany transactions are eliminated from the consolidated financial statements.

##### FOREIGN CURRENCY TRANSLATION

The financial statements of the Company's foreign subsidiaries are measured using the local currency as the functional currency. Net exchange gains or losses resulting from the translation of financial statements of foreign operations and related long-term debt are recorded as a separate component of shareholders' equity. See Note 2 to the Consolidated Financial Statements.

##### INVESTMENTS IN UNCONSOLIDATED ENTITIES

For investments in which the Company owns or controls from 20% to 50% of the voting shares, the equity method of accounting is used. Changes in interest arising from the issuance of stock by an investee is accounted for as additional contributed capital. See Note 6 to the Consolidated Financial Statements.

#### NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

##### REVENUE RECOGNITION

Revenues recognized include product sales, billings for freight and handling charges and fees earned for services provided. The Company recognizes product sales and billings for freight and handling charges primarily on the date products are shipped to, or picked up by, the customer. The Company's standard shipping terms are FOB shipping point. On occasion, the Company will negotiate FOB destination terms. These sales are recognized upon delivery to the customer. Fee revenues, which account for less than 1% of total revenues, are recognized after services are completed.

##### VENDOR CONSIDERATION

The Company accounts for vendor consideration in accordance with Emerging Issues Task Force (EITF) “Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor” (Issue 02-16). The Company provides numerous advertising programs to promote its vendors' products, including catalogs and other printed media, Internet and other marketing programs. Most of these programs relate to multiple vendors, which makes supporting the specific, identifiable and incremental criteria difficult, and would require numerous assumptions and judgments. Based on the inexact nature of trying to track reimbursements to the exact advertising expenditure for each vendor, the Company treats most vendor advertising allowances as a reduction of cost of merchandise sold rather than a reduction of operating (advertising) expenses. Rebates earned from vendors that are based on purchases are capitalized into inventory as part of product purchase price. These rebates are credited to cost of merchandise sold based on sales. Vendor rebates that are earned based on product sales are credited directly to cost of merchandise sold.

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#### COST OF MERCHANDISE SOLD

Cost of merchandise sold includes product and product-related costs, vendor consideration, freight-out costs and handling costs. The Company defines handling costs as those costs incurred to fulfill a shipped sales order.

#### WAREHOUSING, MARKETING AND ADMINISTRATIVE EXPENSES

Included in this category are purchasing, branch operations, information services, and marketing and selling expenses, as well as other types of general and administrative costs.

#### STOCK INCENTIVE PLANS

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123R). SFAS No. 123R revised SFAS No. 123 to require companies to measure all stock-based compensation awards using a fair value method and recognize the related compensation cost in their financial statements. Effective January 1, 2006, the Company adopted SFAS No. 123R using the modified prospective method. Under this transition method, compensation cost recognized in 2006 includes: (a) compensation costs for all share-based payments granted prior to, but not fully vested as of January 1, 2006, based on the grant date fair value as calculated under the pro forma disclosure-only expense provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with provisions of SFAS No. 123R. The adoption of SFAS No. 123R primarily resulted in compensation expense being recorded for stock options. The results for prior periods have not been restated.

For the year ended December 31, 2006, the Company recorded pretax compensation expense of \$19.9 million (\$12.2 million net of tax, or \$0.14 per basic and diluted share) related to the expensing of the Company's non-qualified stock options. For 2006, the fair value of options was estimated using a binomial lattice model. If the tax deductions realized in the Company's income tax return exceed the amount of the tax benefit recognized in the financial statements, the excess tax benefit is recorded as an increase to additional contributed capital. For the year ended December 31, 2006, \$13.4 million of excess tax benefits were realized and reflected as a source of cash from financing activities in the condensed consolidated statements of cash flows. If SFAS No. 123R had not been adopted, this \$13.4 million would have been reflected as a source of cash from operating activities.

Prior to January 1, 2006, the Company applied Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB No. 25), and related interpretations in accounting for its stock-based compensation plans. Under APB No. 25, no compensation expense was recognized for non-qualified stock option awards as the exercise price of the awards on the date of grant was equal to the current market price of the Company's stock. The Company also provided the disclosure-only pro forma expense provision of SFAS No. 123 in its footnotes.

For the years ended December 31, 2005 and 2004, the following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation. For the purposes of this pro forma disclosure, the value of options was estimated using a Black-Scholes option-pricing model.

	For the Years Ended December 31,	
	2005	2004
	(In thousands of dollars, except for per share amounts)	
Net earnings, as reported .....	\$346,324	\$286,923
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax .....	(16,733)	(20,940)
Add: Stock-based employee compensation cost, net of related tax, included in net earnings, as reported .....	6,644	7,256
Net earnings, pro forma .....	<u>\$336,235</u>	<u>\$273,239</u>
Earnings per share:		
Basic – as reported .....	\$ 3.87	\$ 3.18
Basic – pro forma .....	\$ 3.75	\$ 3.03
Diluted – as reported .....	\$ 3.78	\$ 3.13
Diluted – pro forma .....	\$ 3.65	\$ 2.97

## ADVERTISING

Advertising costs are expensed in the year the related advertisement is first presented. Advertising expense was \$115.4 million, \$102.3 million and \$98.2 million for 2006, 2005 and 2004, respectively. The majority of vendor provided allowances are classified as an offset to cost of merchandise sold. Any reimbursements from vendors that are classified as an offset against operating (advertising) costs are recorded when the related advertising is expensed. For additional information see subsection VENDOR CONSIDERATION.

For interim reporting purposes, advertising expense is amortized equally over each period, based on estimated expenses for the full year. Advertising costs for media that have not been distributed by year-end are capitalized as Prepaid expenses. Amounts included in Prepaid expenses at December 31, 2006, 2005 and 2004 were \$30.2 million, \$20.8 million and \$18.2 million, respectively.

## SOFTWARE COSTS

The Company does not sell, lease or market software.

## INCOME TAXES

The Company accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." Income taxes are recognized during the year in which transactions enter into the determination of financial statement income, with deferred taxes being provided for temporary differences between financial and tax reporting.

## OTHER COMPREHENSIVE EARNINGS (LOSSES)

The Company's Other comprehensive earnings (losses) include foreign currency translation adjustments and unrecognized (losses) on postretirement and other employment-related benefit plans. Through the third quarter of 2004, the foreign currency translation adjustments were partially offset by the after-tax effects of a designated hedge.

The following table sets forth the components of Accumulated other comprehensive earnings (losses), net of related income tax effects (in thousands of dollars):

	As of December 31,		
	2006	2005	2004
Foreign currency translation adjustments .....	\$ 26,254	\$27,435	\$18,052
Effect of adopting SFAS No. 158 related to postretirement benefit plans.....	(22,503)	—	—
Unrecognized (losses) on other employment-related benefit plans.....	(320)	(353)	—
Total accumulated other comprehensive earnings (losses).....	<u>\$ 3,431</u>	<u>\$27,082</u>	<u>\$18,052</u>

As described in Note 2 – NEW ACCOUNTING STANDARDS, the Company adopted SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans." SFAS No. 158 requires a transition year disclosure of the effect of applying the new standard.

The following table shows the effects of applying SFAS No. 158 on comprehensive earnings and other individual line items in the consolidated financial statements of the Company.

	Incremental Effect of Applying SFAS No. 158		
	December 31, 2006		
	(In thousands of dollars)		
	Before Application of SFAS No. 158	Effect of SFAS No. 158 Adoption	After Application of SFAS No. 158
Accrued employment-related benefit costs .....	\$ (114,237)	\$(36,783)	\$ (151,020)
Deferred income taxes .....	\$ 34,513	\$ 14,280	\$ 48,793
Accumulated other comprehensive earnings (losses), net of tax .....	\$ (25,934)	\$ 22,503	\$ (3,431)
Total shareholders' equity .....	\$(2,200,118)	\$ 22,503	\$(2,177,615)
Total liabilities and equity .....	\$(3,068,591)	\$ 22,503	\$(3,046,088)

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CASH AND MARKETABLE SECURITIES

The Company considers investments in highly liquid debt instruments, purchased with an original maturity of ninety days or less, to be cash equivalents. For cash equivalents, the carrying amount approximates fair value due to the short maturity of these instruments.

The Company's investments in marketable securities consist of commercial paper to be held to maturity. The investments are issued from high credit quality issuers. The marketable securities are recorded at cost which is considered to approximate fair value. These investments have an original maturity date of more than 90 days.

CONCENTRATION OF CREDIT RISK

The Company places temporary cash investments with institutions of high credit quality and, by policy, limits the amount of credit exposure to any one institution.

The Company has a broad customer base representing many diverse industries doing business in all regions of the United States as well as other areas of North America. Consequently, no significant concentration of credit risk is considered to exist.

ALLOWANCE FOR DOUBTFUL ACCOUNTS

The Company establishes reserves for customer accounts that are potentially uncollectible. The method used to estimate the allowances is based on several factors including the age of the receivables and the historical ratio of actual write-offs to the age of the receivables. These analyses also take into consideration economic conditions that may have an impact on a specific industry, group of customers or a specific customer. Write-offs could be materially different than the reserves provided if economic conditions change or actual results deviate from historical trends.

INVENTORIES

Inventories are valued at the lower of cost or market. Cost is determined primarily by the last-in, first-out (LIFO) method, which accounts for approximately 77% of total inventory. For the remaining inventory, cost is determined by the first-in, first-out (FIFO) method.

PROPERTY, BUILDINGS AND EQUIPMENT

Property, buildings and equipment are valued at cost. For financial statement purposes, depreciation and amortization are provided in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives, principally on the declining-balance and sum-of-the-years-digits methods. The principal estimated useful lives for determining depreciation are as follows:

Buildings, structures and improvements .....	10 to 45 years
Furniture, fixtures, machinery and equipment .....	3 to 10 years

Improvements to leased property are amortized over the initial terms of the respective leases or the estimated service lives of the improvements, whichever is shorter.

The Company capitalized interest costs of \$0.3 million, \$0.3 million and \$0.2 million in 2006, 2005 and 2004, respectively.

LONG-LIVED ASSETS

The carrying value of long-lived assets is evaluated whenever events or changes in circumstances indicate that the carrying value of the asset may be impaired. An impairment loss is recognized when estimated undiscounted future cash flows resulting from use of the asset, including disposition, is less than the carrying value of the asset. Impairment is measured as the amount by which the carrying amount exceeds the fair value.

GOODWILL AND OTHER INTANGIBLES

The Company follows SFAS No. 142, "Goodwill and Other Intangible Assets," in accounting for goodwill and other intangibles. Under SFAS No. 142, goodwill is recognized as the excess cost of an acquired entity over the net amount assigned to assets acquired and liabilities assumed. Goodwill is not amortized, but rather tested for impairment on an annual basis and more often if circumstances require. Impairment losses are recognized whenever the implied fair value of goodwill is less than its carrying value.

The Company recognizes an acquired intangible apart from goodwill whenever the intangible arises from contractual or other legal rights, or whenever it can be separated or divided from the acquired entity and sold, transferred, licensed, rented or exchanged, either individually or in combination with a related contract, asset or liability. Such intangibles are amortized over their estimated useful lives unless the estimated useful life is determined to be indefinite. Amortizable intangible assets are being amortized over useful lives of three to 17 years. Impairment losses are recognized if the carrying amount of an intangible, subject to amortization, is not recoverable from expected future cash flows and its carrying amount exceeds its fair value.

The Company also maintains intangible assets with indefinite lives, which are not amortized. These intangibles are tested for impairment on an annual basis and more often if circumstances require, similar to the treatment for goodwill. Impairment losses are recognized whenever the implied fair value of these assets is less than their carrying value.

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## INSURANCE RESERVES

The Company purchases insurance for catastrophic exposures and those risks required to be insured by law. It also retains a significant portion of the risk of losses related to workers' compensation, general liability and property. Reserves for these potential losses are based on an external analysis of the Company's historical claims results and other actuarial assumptions.

## WARRANTY RESERVES

The Company generally warrants the products it sells against defects for one year. For a significant portion of warranty claims, the manufacturer of the product is responsible for the expenses. For warranty expenses not covered by the manufacturer, the Company provides a reserve for future costs based primarily on historical experience. The reserve activity was as follows (in thousands of dollars):

	As of December 31,		
	2006	2005	2004
Beginning balance .....	\$ 3,763	\$ 3,428	\$ 2,863
Returns .....	(7,641)	(9,179)	(9,908)
Provisions .....	8,529	9,514	10,473
Ending balance .....	<u>\$ 4,651</u>	<u>\$ 3,763</u>	<u>\$ 3,428</u>

## NEW ACCOUNTING STANDARDS

In February 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, "Accounting for Certain Hybrid Financial Instruments – an amendment of FASB Statements No. 133 and 140." SFAS No. 155 allows companies to elect to measure at fair value entire financial instruments containing embedded derivatives that would otherwise have to be accounted for separately. It also requires companies to identify interests in securitized financial assets that are freestanding derivatives or contain embedded derivatives that would have to be accounted for separately, clarifies which interest- and principal-only strips are subject to SFAS No. 133, and amends SFAS No. 140 to revise the conditions of a qualifying special purpose entity due to the new requirement to identify whether interests in securitized financial assets are freestanding derivatives or contain embedded derivatives. SFAS No. 155 is effective for all financial instruments acquired, issued or subject to a remeasurement event after the beginning of a company's first fiscal year that begins after September 15, 2006. The Company does not expect adoption of SFAS No. 155 to have a material effect on its results of operations or financial position.

In March 2006, the FASB issued SFAS No. 156, "Accounting for Servicing of Financial Assets – an amendment of FASB Statement No. 140." SFAS No. 156 requires the recognition of a servicing asset or liability each time a company undertakes an obligation to service a financial asset in certain situations. It requires all separately recognized servicing assets and liabilities to be initially measured at fair value, if practical. SFAS No. 156 is effective as of the beginning of a company's first fiscal year that begins after September 15, 2006. The Company does not expect adoption of SFAS No. 156 to have a material effect on its results of operations or financial position.

In June 2006, the Emerging Issues Task Force (EITF) reached a consensus with respect to EITF Issue 06-2, "Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, Accounting for Compensated Absences." Under Issue 06-2, an employee's right to a compensated absence under a sabbatical or similar benefit arrangement in which the employee is not required to perform any duties during the absence "accumulates" and therefore should be accounted for as a liability if the other conditions for recognition in SFAS No. 43 are met. The other conditions in SFAS No. 43 are that the obligation relates to services already rendered, payment is probable and the amount can be reasonably estimated. Issue 06-2 is effective for fiscal years beginning after December 15, 2006, with early application permitted. The Company does not expect adoption of Issue 06-2 to have a material effect on its results of operations or financial position.

In June 2006, the EITF reached a consensus with respect to EITF Issue 06-3, "How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)." Issue 06-3 permits the presentation of sales and other taxes on either a gross (included in revenues and costs) or net (excluded from revenues) basis and is an accounting policy decision that should be disclosed pursuant to APB Opinion No. 22, "Disclosures of Accounting Policies." If reported on a gross basis, the amount of any such taxes should be disclosed in interim and annual financial statements. The effective date is for disclosures presented for interim and annual financial periods beginning after December 15, 2006. The Company does not expect to change its presentation of sales and other taxes, which is currently on a net basis.

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In July 2006, the FASB issued Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109." FIN 48 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measure of a tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company does not expect adoption of FIN 48 to have a material effect on its results of operations or financial position.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles and expands disclosures about fair value measurements. The provisions of SFAS No. 157 are effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the effect adoption may have on its results of operations or financial position.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106, and 132R." SFAS No. 158 requires an employer to recognize in its statement of financial position an asset for a plan's overfunded status or a liability for a plan's underfunded status, measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year (with limited exceptions), and recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. SFAS No. 158 requires funded status changes of a defined benefit postretirement plan within accumulated other comprehensive income, net of tax, to the extent such changes are not recognized in earnings as components of net periodic benefit costs. SFAS No. 158 is effective for fiscal years ending after December 15, 2006. The Company adopted SFAS No. 158 during the fourth quarter of 2006. As a result of the adoption, Grainger recorded an additional liability of \$36.8 million to Accrued employment-related benefit costs offset by \$14.3 million of deferred income taxes and a reduction of Accumulated other comprehensive earnings of \$22.5 million. See Note 2 – OTHER COMPREHENSIVE EARNINGS (LOSSES) for further detail related to the effects of the adoption.

In September 2006, the EITF reached a consensus on Issue 06-5, "Accounting for Purchases of Life Insurance – Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance." Issue 06-5 provides guidance on how an entity should determine the amount that could be realized under an insurance contract at the balance sheet date. This guidance requires that the cash surrender value and any additional amounts provided by the contractual terms of the life insurance policy that are realizable at the balance sheet date should be considered in determining the amount that could be realized. This guidance is effective for reporting periods beginning after December 15, 2006. The Company does not expect adoption of Issue 06-5 to have a material effect on its results of operations or financial position.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in the Current Year Financial Statements." SAB No. 108 addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements. SAB No. 108 requires an entity to quantify misstatements using a balance sheet and income statement approach, and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. The adoption of SAB No. 108 is effective for fiscal years ending on or after November 15, 2006. The Company adopted SAB No. 108 during the fourth quarter of 2006. The adoption of SAB No. 108 did not have a material effect on the Company's results of operations or financial position.

### **NOTE 3 – BUSINESS ACQUISITIONS**

On November 17, 2006, Lab Safety Supply, Inc. (Lab Safety), a wholly owned subsidiary of the Company, acquired substantially all of the assets and assumed certain liabilities of Professional Inspection Equipment, Inc. (Professional Equipment) and Construction Book Express, Inc. (Construction Book). The companies are direct marketers of tools, instruments and reference materials to the building and home inspection markets. The companies had annual sales in 2005 of more than \$18 million. The aggregate purchase price for the two companies was approximately \$20.5 million in cash and \$1.7 million in assumed liabilities. The estimated goodwill recognized in the transaction amounted to \$18.4 million and is expected to be fully deductible for tax purposes.

On January 31, 2006, Lab Safety acquired substantially all of the assets and assumed certain liabilities of Rand Materials Handling Equipment Co. (Rand). Rand is a national catalog distributor of warehouse, storage and packaging supplies. Rand had more than \$16 million in sales in 2005. The aggregate purchase price for Rand was \$13.9 million in cash and \$2.3 million in assumed liabilities. The goodwill recognized in the transaction amounted to \$9.9 million and is expected to be fully deductible for tax purposes.

On January 14, 2005, Lab Safety acquired substantially all of the assets and assumed certain liabilities of AW Direct, Inc. (AW Direct). AW Direct, a targeted direct marketer of products to the service vehicle accessories market, had sales of more than \$28 million in 2004. The aggregate purchase price was \$24.8 million in cash and \$2.0 million in assumed liabilities. Goodwill recognized in this transaction amounted to \$14.0 million and is expected to be fully deductible for tax purposes.

The results of these acquisitions are included in the Company's consolidated results from the respective dates of acquisition. Due to the immaterial nature of these transactions, disclosures of amounts assigned to the acquired assets and assumed liabilities and pro forma results of operations were not considered necessary.

#### NOTE 4 – ALLOWANCE FOR DOUBTFUL ACCOUNTS

The following table shows the activity in the allowance for doubtful accounts (in thousands of dollars):

	For the Years Ended December 31,		
	2006	2005	2004
Balance at beginning of period .....	\$ 18,401	\$ 23,375	\$ 24,736
Provision for uncollectible accounts .....	6,057	1,326	5,159
Write-off of uncollectible accounts, less recoveries .....	(5,660)	(6,380)	(6,662)
Foreign currency exchange impact .....	3	80	142
Balance at end of period .....	<u>\$ 18,801</u>	<u>\$ 18,401</u>	<u>\$ 23,375</u>

#### NOTE 5 – INVENTORIES

Inventories primarily consist of merchandise purchased for resale.

Inventories would have been \$270.0 million, \$246.3 million and \$238.4 million higher than reported at December 31, 2006, 2005 and 2004, respectively, if the FIFO method of inventory accounting had been used for all Company inventories. Net earnings would have increased by \$14.5 million, \$4.9 million and \$2.4 million for the years ended December 31, 2006, 2005 and 2004, respectively, using the FIFO method of accounting. Inventory values using the FIFO method of accounting approximate replacement cost.

#### NOTE 6 – INVESTMENTS IN UNCONSOLIDATED ENTITIES

The table below summarizes the activity of these investments (in thousands of dollars):

	MonotaRO Co., Ltd.	USI-AGI Prairies Inc.	Total
Balance at January 1, 2004 .....	\$ 2,874	\$ 19,948	\$ 22,822
Equity (loss) earnings .....	(1,107)	2,103	996
Foreign currency gain .....	524	1,784	2,308
Balance at December 31, 2004 .....	2,291	23,835	26,126
Equity earnings .....	472	2,337	2,809
Loan repayment .....	—	(3,706)	(3,706)
Foreign currency (loss) gain .....	(329)	255	(74)
Balance at December 31, 2005 .....	2,434	22,721	25,155
Cash investments .....	3,988	—	3,988
Equity earnings .....	1,826	1,134	2,960
Divestiture .....	—	(24,967)	(24,967)
Change in interest due to issuance of stock .....	453	—	453
Foreign currency (loss) gain .....	(209)	1,112	903
Balance at December 31, 2006 .....	<u>\$ 8,492</u>	<u>\$ —</u>	<u>\$ 8,492</u>
Ownership interest at December 31, 2006 .....	38%	0%	

The Company has investments in two Asian companies accounted for under the equity method of accounting. At December 31, 2006, the ownership percentages of the two investments were 49% and 38%. In the fourth quarter of 2003, the Company wrote off its investment in the joint venture in Korea (49% ownership interest) and suspended recognition of equity income. Even though the business is marginally profitable and self-funding, it currently has only one significant customer (the other party in the joint venture) and will need to secure sufficient capital funding in order to grow.

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In the first quarter of 2006, the Company contributed \$4.0 million to MonotaRO Co., Ltd., its 38% owned company in Japan. In the fourth quarter of 2006, an initial public offering by this company resulted in a change of interest of \$0.5 million, recorded as additional contributed capital. The market value of this investment, based on the closing stock price on February 20, 2007, was \$40.1 million.

On February 23, 2006, Acklands – Grainger Inc. (Acklands – Grainger), the Company's Canadian subsidiary, received a Notice of Purchase advising Acklands – Grainger that Uni-Select Inc., a Canadian company, was exercising its contractual option to purchase all of Acklands – Grainger's shares in the USI-AGI Prairies Inc. joint venture. The transaction closed on May 31, 2006, for Canadian \$30.9 million (US\$27.8 million), resulting in a US\$2.3 million pre-tax gain for the Company. The Company's 50% ownership investment in this joint venture was previously accounted for under the equity method of accounting. The carrying value of this investment included US\$5.1 million of allocated goodwill. The joint venture was managed by Uni-Select.

#### **NOTE 7 – CAPITALIZED SOFTWARE**

Amortization of capitalized software is on a straight-line basis over three and five years. Amortization begins when the software is available for its intended use. Amortization expense was \$12.6 million, \$7.6 million and \$10.7 million for the years ended December 31, 2006, 2005 and 2004, respectively. The Company reviews the amounts capitalized for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. In 2004, the Company determined certain capitalized amounts were no longer recoverable and wrote down their carrying value by \$1.0 million.

#### **NOTE 8 – SHORT-TERM DEBT**

The Company and its subsidiaries had committed lines of credit totaling \$250.0 million at December 31, 2006, 2005 and 2004, for which the Company compensated a bank through a commitment fee of 0.04% in 2006 and 0.07% in 2005 and 2004. There were no borrowings under the committed lines of credit.

The Company also had \$8.6 million, \$8.6 million and \$8.3 million of uncommitted lines of credit denominated in Canadian dollars at December 31, 2006, 2005 and 2004, respectively. There were no borrowings under the committed lines of credit.

The Company had \$15.8 million, \$15.8 million and \$16.0 million of letters of credit at December 31, 2006, 2005 and 2004, respectively, primarily related to the Company's casualty insurance program. The Company also had \$3.3 million, \$1.4 million and \$0.9 million at December 31, 2006, 2005 and 2004, respectively, in letters of credit to facilitate the purchase of product from foreign sources.

#### **NOTE 9 – EMPLOYEE BENEFITS**

##### Retirement Plans

A majority of the Company's employees are covered by a noncontributory profit sharing plan. This plan provides for annual employer contributions generally based upon a formula related primarily to earnings before federal income taxes, limited to 25% of the total eligible compensation paid to all eligible employees. The Company also sponsors additional defined contribution plans, which cover most of the other employees. Provisions under all plans were \$114.3 million, \$92.8 million and \$74.2 million for the years ended December 31, 2006, 2005 and 2004, respectively.

##### Postretirement Benefits

The Company has a postretirement healthcare benefits plan that provides coverage for a majority of its employees and their dependents should they elect to maintain such coverage upon retirement. Covered employees become eligible for participation when they qualify for retirement while working for the Company. Participation in the plan is voluntary and requires participants to make contributions toward the cost of the plan, as determined by the Company.

The Company's accumulated postretirement benefit obligation (APBO) and net periodic benefit costs include the effect of the federal subsidy provided by the "Medicare Prescription Drug, Improvement and Modernization Act of 2003" (the Medicare Act). The Medicare Act provides a federal subsidy to retiree healthcare benefit plan sponsors that provide a prescription drug benefit that is at least actuarially equivalent to that provided by Medicare, with subsidy payments beginning January 1, 2006. The Company first reflected the effect of the subsidy in 2004. As a result of the subsidy, the APBO has been reduced by \$33.4 million, \$30.6 million and \$20.8 million as of December 31, 2006, 2005 and 2004, respectively. The net periodic benefit costs have been reduced by approximately \$5.6 million, \$4.4 million and \$3.8 million for the years ended December 31, 2006, 2005 and 2004, respectively.

The net periodic benefits costs charged to operating expenses, which were valued with a measurement date of January 1 for each year, including the effect of the Medicare Act in 2006, 2005 and 2004, consisted of the following components:

	For the Years Ended December 31,		
	2006	2005	2004
	(In thousands of dollars)		
Service cost.....	\$ 9,737	\$ 7,577	\$ 6,380
Interest cost.....	7,599	6,287	5,292
Expected return on assets .....	(2,790)	(2,502)	(2,064)
Amortization of transition asset .....	(143)	(143)	(143)
Amortization of unrecognized losses .....	2,903	1,923	1,371
Amortization of prior service cost.....	(858)	(858)	(858)
Net periodic benefits costs .....	<u>\$ 16,448</u>	<u>\$ 12,284</u>	<u>\$ 9,978</u>

The Company has elected to amortize the amount of net unrecognized losses over a period equal to the average remaining service period for active plan participants expected to retire and receive benefits, or approximately 17.2 years for 2006.

Reconciliations of the beginning and ending balances of the APBO, which is calculated using a December 31 measurement date, the fair value of assets and the funded status of the benefit obligation follow:

	2006	2005	2004
	(In thousands of dollars)		
Benefit obligation at the beginning of the year .....	\$127,598	\$103,381	\$107,710
Service cost.....	9,737	7,577	6,380
Interest cost.....	7,599	6,287	5,292
Plan participant contributions.....	1,670	1,527	1,364
Amendments .....	5,559	—	(2,843)
Actuarial losses (gains) .....	7,359	12,843	(11,194)
Benefits paid .....	(4,277)	(4,017)	(3,328)
Medicare Part D Subsidy payments received.....	108	—	—
Benefit obligation at the end of the year .....	<u>155,353</u>	<u>127,598</u>	<u>103,381</u>
Fair value of plan assets at the beginning of the year .....	46,503	41,706	34,405
Actual returns on plan assets.....	6,192	1,515	3,026
Employer contributions.....	17,398	5,772	6,239
Plan participant contributions.....	1,670	1,527	1,364
Benefits paid .....	(4,277)	(4,017)	(3,328)
Fair value of plan assets at the end of the year .....	<u>67,486</u>	<u>46,503</u>	<u>41,706</u>
Funded status.....	(87,867)	(81,095)	(61,675)
Unrecognized transition asset.....	—	(1,285)	(1,428)
Unrecognized net actuarial losses.....	—	38,065	26,157
Unrecognized prior service cost .....	—	(8,014)	(8,872)
Accrued postretirement benefits cost .....	<u>\$ (87,867)</u>	<u>\$ (52,329)</u>	<u>\$ (45,818)</u>

The benefit obligation was determined by applying the terms of the plan and actuarial models required by SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." These models include various actuarial assumptions, including discount rates, assumed rates of return on plan assets and healthcare cost trend rates. The actuarial assumptions also anticipate future cost-sharing changes to retiree contributions that will maintain the current cost-sharing ratio between the Company and the retirees. The Company evaluates its actuarial assumptions on an annual basis and considers changes in these long-term factors based upon market conditions, historical experience and the requirements of SFAS No. 106.

The plan amendment effective January 1, 2007 (reflected in the 2006 valuation above) changed the retiree contributions percentages for certain age groups.

The plan amendment effective January 1, 2004, changed the retiree co-payments, coinsurance amounts and out-of-pocket maximums for participants.

The following assumptions were used to determine benefit obligations at December 31:

	2006	2005	2004
Discount rate .....	5.90%	5.50%	5.75%
Expected long-term rate of return on plan assets, net of tax at 40% .....	6.00%	6.00%	6.00%
Initial healthcare cost trend rate .....	10.00%	10.00%	10.00%
Ultimate healthcare cost trend rate .....	5.00%	5.00%	5.00%
Year ultimate healthcare cost trend rate reached .....	2017	2016	2016

The following assumptions were used to determine net periodic benefit cost for years ended December 31:

	2006	2005	2004
Discount rate .....	5.50%	5.75%	6.00%
Expected long-term rate of return on plan assets, net of tax at 40% .....	6.00%	6.00%	6.00%
Initial healthcare cost trend rate .....	10.00%	10.00%	10.00%
Ultimate healthcare cost trend rate .....	5.00%	5.00%	5.00%
Year ultimate healthcare cost trend rate reached .....	2016	2016	2016

The discount rate assumptions reflect the rates available on high-quality fixed income debt instruments on December 31 of each year. These rates have been selected due to their similarity to the projected cash flows of the postretirement healthcare benefit plan.

The Company reviews external data and its own historical trends for healthcare costs to determine the healthcare cost trend rates. Assumed healthcare cost trend rates have a significant effect on the amounts reported for the healthcare plans. A 1 percentage point change in assumed healthcare cost trend rates would have the following effects on December 31, 2006 results:

	1 Percentage Point	
	Increase	(Decrease)
	(In thousands of dollars)	
Effect on total of service and interest cost .....	\$ 4,102	\$ (3,164)
Effect on accumulated postretirement benefit obligation.....	30,382	(24,130)

The Company has established a Group Benefit Trust to fund the plan and process benefit payments. The assets of the trust are invested entirely in funds designed to track the Standard & Poor's 500 Index (S&P 500). This investment strategy reflects the long-term nature of the plan obligation and seeks to take advantage of the superior earnings potential of equity securities. The Company uses the long-term historical return on the plan assets and the historical performance of the S&P 500 to develop its expected return on plan assets. The required use of an expected long-term rate of return on plan assets may result in recognizing income that is greater or less than the actual return on plan assets in any given year.

Over time, however, the expected long-term returns are designed to approximate the actual long-term returns and, therefore, result in a pattern of income recognition that more closely matches the pattern of the services provided by the employees.

The funding of the trust is an estimated amount which is intended to allow the maximum deductible contribution under the Internal Revenue Code of 1986 (IRC), as amended, and was \$17.4 million, \$5.8 million and \$6.2 million, for the years ended December 31, 2006, 2005 and 2004, respectively. During those years, \$2.6 million, \$2.5 million and \$2.0 million, respectively, were used directly for benefit payments. There are no minimum funding requirements and the Company intends to follow its practice of funding the maximum deductible contribution under the IRC.

The Company forecasts the following benefit payments (which include a projection for expected future employee service) and subsidy receipts (in thousands of dollars):

	Estimated gross benefit payments	Estimated Medicare subsidy receipts
2007.....	\$ 3,496	\$ (324)
2008.....	3,964	(391)
2009.....	4,556	(461)
2010.....	5,255	(545)
2011.....	6,102	(635)
2012 – 2016.....	\$47,708	\$(5,027)

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### Executive Death Benefit Plan

The Executive Death Benefit Plan provides one of three potential benefits: a supplemental income benefit (SIB), an executive death benefit (EDB) or a postretirement payment. The SIB provides income continuation at 50% of total compensation, payable for ten years to the beneficiary of a participant if that participant dies while employed by the Company. Alternatively, the EDB provides an after-tax lump sum payment of one times final total compensation to the beneficiary of a participant who dies after retirement. In addition, a participant may elect to receive a reduced postretirement payment instead of the EDB. Plan participation is determined by a committee of management. There are no plan assets. Benefits are paid as they come due from the general assets of the Company.

The net periodic benefits costs charged to operating expenses, which were valued with a measurement date of January 1 for each year, consisted of the following components:

	For the Years Ended December 31,		
	2006	2005	2004
	(In thousands of dollars)		
Service cost .....	\$ 361	\$ 277	\$ 242
Interest cost .....	850	791	869
Amortization of unrecognized losses .....	154	69	185
Net periodic benefits costs .....	<u>\$ 1,365</u>	<u>\$ 1,137</u>	<u>\$ 1,296</u>

Reconciliations of the beginning and ending balances of the projected benefit obligation, which is calculated using a December 31 measurement date, the fair value of assets and the status of the benefit obligation follow:

	2006	2005	2004
	(In thousands of dollars)		
Benefit obligation at the beginning of the year .....	\$ 15,222	\$ 13,921	\$ 14,660
Service cost .....	361	277	242
Interest cost .....	850	791	869
Actuarial (gains) losses .....	(1,095)	562	(1,126)
Benefits paid .....	(432)	(329)	(724)
Benefit obligation at the end of the year .....	<u>14,906</u>	<u>15,222</u>	<u>13,921</u>
Fair value of plan assets at the beginning of the year .....	—	—	—
Employer contributions .....	432	329	724
Benefits paid .....	(432)	(329)	(724)
Fair value of plan assets at the end of the year .....	<u>—</u>	<u>—</u>	<u>—</u>
Benefit obligation .....	(14,906)	(15,222)	(13,921)
Unrecognized net actuarial losses .....	<u>—</u>	<u>1,485</u>	<u>992</u>
Accrued postretirement benefits cost .....	<u>\$ (14,906)</u>	<u>\$ (13,737)</u>	<u>\$ (12,929)</u>

The benefit obligation was determined by applying the terms of the plan and actuarial models required by SFAS No. 87, "Employers' Accounting for Pensions." These models include various actuarial assumptions, including discount rates, mortality and salary progression. The Company evaluates its actuarial assumptions on an annual basis and considers changes in these long-term factors based upon market conditions, historical experience and the requirements of SFAS No. 87.

The following assumptions were used to determine benefit obligations at December 31:

	2006	2005	2004
Discount rate used to determine benefit obligation .....	5.90%	5.50%	5.75%
Discount rate used to determine net periodic benefit cost .....	5.50%	5.75%	6.00%
Compensation increase used to determine obligation and cost .....	4.00%	4.00%	4.00%

The discount rate assumptions reflect the rates available on high-quality fixed income debt instruments on December 31 of each year. These rates have been selected due to their similarity to the projected cash flows of the Executive Death Benefit Plan.

Projected future benefit payments (in thousands of dollars):

	Benefit Payments
2007 .....	\$ 454
2008 .....	551
2009 .....	604
2010 .....	658
2011 .....	715
2012 – 2016 .....	\$4,632

#### Deferred Compensation Plans

The Executive Deferred Compensation Plans are money purchase defined benefit plans. This benefit is reduced for early retirement. Plan participation was limited to Company executives during the years 1984 to 1986; no new executives have been added since that time. Participants were allowed to defer a portion of their compensation for the years 1984 through 1990. In return, under the plan, each participant receives an individually specified benefit at age 65. There are no plan assets. Benefits are paid as they come due from the general assets of the Company.

The net periodic benefits costs charged to operating expenses, which were valued with a measurement date of January 1 for each year, consisted of the following components:

	For the Years Ended December 31,		
	2006	2005	2004
	(In thousands of dollars)		
Interest cost .....	\$ 573	\$ 610	\$ 659
Amortization of unrecognized losses .....	184	108	28
Net periodic benefits costs .....	<u>\$ 757</u>	<u>\$ 718</u>	<u>\$ 687</u>

Reconciliations of the beginning and ending balances of the projected benefit obligation, which is calculated using a December 31 measurement date, the fair value of assets and the status of the benefit obligation follow:

	2006	2005	2004
	(In thousands of dollars)		
Benefit obligation at the beginning of the year .....	\$ 11,419	\$ 11,550	\$ 11,401
Interest cost .....	573	610	659
Actuarial losses .....	129	179	394
Benefits paid .....	(1,176)	(920)	(904)
Benefit obligation at the end of the year .....	<u>10,945</u>	<u>11,419</u>	<u>11,550</u>
Fair value of plan assets at the beginning of the year .....	—	—	—
Employer contributions .....	1,176	920	904
Benefits paid .....	(1,176)	(920)	(904)
Fair value of plan assets at the end of the year .....	—	—	—
Benefit obligation .....	(10,945)	(11,419)	(11,550)
Unrecognized net actuarial losses .....	—	579	508
Accrued postretirement benefits cost .....	<u>\$ (10,945)</u>	<u>\$ (10,840)</u>	<u>\$ (11,042)</u>

The benefit obligation was determined by applying the terms of the plan and actuarial models required by SFAS No. 87, "Employers' Accounting for Pensions." These models include various actuarial assumptions, including discount rates, mortality and retirement age. The Company evaluates its actuarial assumptions on an annual basis and considers changes in these long-term factors based upon market conditions, historical experience and the requirements of SFAS No. 87.

The following assumptions were used to determine benefit obligations at December 31:

	2006	2005	2004
Discount rate used to determine benefit obligation .....	5.50%	5.25%	5.50%
Discount rate used to determine net periodic benefit cost .....	5.25%	5.50%	6.00%

The discount rate assumptions reflect the rates available on high-quality fixed income debt instruments on December 31 of each year. These rates have been selected due to their similarity to the projected cash flows of the Executive Deferred Compensation Plans.

Projected future benefit payments (in thousands of dollars):

	Benefit Payments
2007 .....	\$1,229
2008 .....	1,205
2009 .....	1,205
2010 .....	1,165
2011 .....	1,133
2012 – 2016 .....	\$5,254

#### Other Postretirement Benefits

Certain of the Company's non-U.S. subsidiaries provide limited non-pension benefits to retirees in addition to government-mandated programs. The cost of these programs is not significant to the Company. Most retirees outside the United States are covered by government-sponsored and administered programs.

#### **NOTE 10 – LONG-TERM DEBT**

Long-term debt consisted of the following:

	As of December 31,		
	2006	2005	2004
	(In thousands of dollars)		
Industrial development revenue and private activity bonds .....	\$ 9,485	\$ 9,485	\$ 9,485
Less current maturities .....	4,590	4,590	9,485
	<u>\$ 4,895</u>	<u>\$ 4,895</u>	<u>\$ —</u>

During 2002, the Company issued commercial paper in support of a cross-currency swap (derivative instrument). This derivative instrument was designated as a partial hedge of the net investment in the Company's Canadian subsidiary and was recognized on the balance sheet at its fair value.

On September 27, 2004, the two-year cross-currency swap and related commercial paper debt matured and were liquidated with payments totalling US\$140.8 million. While the cross-currency swap was outstanding, the Company formally assessed, on a quarterly basis, whether the cross-currency swap was effective at offsetting changes in the fair value of the underlying exposure. Because of the high degree of effectiveness between the hedging instrument and the underlying exposure being hedged, exchange rate changes in the value of the cross-currency swap were generally offset by changes in the value of the net investment. Under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," changes in the fair value of this instrument were recognized in foreign currency translation adjustments, a component of Accumulated other comprehensive earnings (losses), to offset the change in the value of the net investment of the Canadian investment being hedged. During 2004, the Company recognized a US\$0.6 million net of tax loss related to this hedge, which included the settlement of the cross-currency swap, in Accumulated other comprehensive earnings (losses). The impact to 2004 resulting from the ineffective portion of the hedge was immaterial.

The industrial development revenue and private activity bonds include various issues that bear interest at variable rates capped at 15%, and come due in various amounts from 2009 through 2021. At December 31, 2006, the weighted average interest rate was 4.14%. Interest rates on some of the issues are subject to change at certain dates in the future. The bondholders may require the Company to redeem certain bonds concurrent with a change in interest rates and certain other bonds annually. In addition, \$4.6 million of these bonds had an unsecured liquidity facility available at December 31, 2006, for which the Company compensated a bank through a commitment fee of 0.07%. There were no borrowings related to this facility at December 31, 2006. The Company classified \$4.6 million, \$4.6 million and \$9.5 million of bonds currently subject to redemption options in current maturities of long-term debt at December 31, 2006, 2005 and 2004, respectively.

The Company's debt instruments include only standard affirmative and negative covenants that are normal in debt instruments of similar amounts and structure. The Company's debt instruments do not contain financial or performance covenants restrictive to the business of the Company, reflecting its strong financial position. The Company is in compliance with all debt covenants for the year ended December 31, 2006.

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**NOTE 11 – LEASES**

The Company leases certain land, buildings, and equipment under noncancellable operating leases that expire at various dates through 2036. The Company capitalizes all significant leases that qualify for capitalization, of which there were none at December 31, 2006. Many of the building leases obligate the Company to pay real estate taxes, insurance and certain maintenance costs, and contain multiple renewal provisions, exercisable at the Company's option. Leases that contain predetermined fixed escalations of the minimum rentals are recognized in rental expense on a straight-line basis over the lease term. Cash or rent abatements received upon entering into certain operating leases are also recognized on a straight-line basis over the lease term.

At December 31, 2006, the approximate future minimum lease payments for all operating leases were as follows (in thousands of dollars):

	Future Minimum Lease Payments
2007 .....	\$ 34,221
2008 .....	28,630
2009 .....	23,272
2010 .....	17,351
2011 .....	19,541
Thereafter .....	45,885
Total minimum payments required .....	\$168,900
Less amounts representing sublease income .....	(274)
	<u>\$168,626</u>

Rent expense, including items under lease and items rented on a month-to-month basis, was \$33.4 million, \$28.6 million and \$22.3 million for 2006, 2005 and 2004, respectively. These amounts are net of sublease income of \$0.5 million, \$0.4 million and \$0.5 million for 2006, 2005 and 2004, respectively.

**NOTE 12 – STOCK INCENTIVE PLANS**

The Company maintains stock incentive plans under which the Company may grant a variety of incentive awards to employees and Directors. Shares of common stock were authorized for issuance under the plans in connection with awards of nonqualified stock options, stock appreciation rights, restricted stock, stock units and other stock-based awards. As of December 31, 2006, restricted stock, restricted stock units, performance shares and non-qualified stock options have been granted.

In 2005, the shareholders of the Company approved the 2005 Incentive Plan ("Plan") which replaced all prior active plans ("Prior Plans"). Awards previously granted under Prior Plans will remain outstanding in accordance with their terms but no new awards are allowed. The Plan authorizes the granting of options to purchase shares at a price of not less than 100% of the closing market price on the last trading day preceding the date of grant. All options expire no later than ten years after the date of grant. A total of 9.5 million shares of common stock have been reserved for issuance under the Plan. As of December 31, 2006, there were 5,975,176 shares available for grant under the Plan.

Options

In 2006, 2005 and 2004, the Company provided broad-based stock option grants covering 187,900, 231,500 and 181,200 shares, respectively, to those employees who reached major service milestones and were not participants in other stock option programs.

In 2006, 2005 and 2004, the Company issued stock option grants to employees as part of their incentive compensation. Stock option grants were 1,234,400, 1,183,650 and 1,034,850 for the years 2006, 2005 and 2004, respectively.

In 2004, nonemployee Directors received an annual grant denominated in dollars but settled with options to purchase shares of common stock. The number of options issued was equal to the dollar amount of the grant divided by the fair market value of a share of common stock at the time of the award, rounded to the next ten-share increment. The number of options was 13,360 for 2004. The options were fully exercisable upon award and have a ten-year term.

Option awards are granted with an exercise price equal to the closing market price of the Company's stock on the last trading day preceding the date of grant. The options generally vest over three years and generally expire ten years from the grant date.

Transactions involving stock options are summarized as follows:

	Shares Subject to Option	Weighted Average Price Per Share	Options Exercisable
Outstanding at January 1, 2004 .....	10,413,932	\$44.91	<u>4,148,846</u>
Granted .....	1,229,410	\$53.25	
Exercised .....	(1,885,415)	\$40.08	
Canceled or expired .....	<u>(552,133)</u>	\$47.54	
Outstanding at December 31, 2004 .....	9,205,794	\$46.86	<u>4,415,343</u>
Granted .....	1,415,150	\$54.20	
Exercised .....	(1,550,316)	\$44.51	
Canceled or expired .....	<u>(378,788)</u>	\$48.98	
Outstanding at December 31, 2005 .....	8,691,840	\$48.37	<u>4,572,250</u>
Granted .....	1,422,300	\$75.87	
Exercised .....	(1,390,461)	\$46.35	
Canceled or expired .....	<u>(268,810)</u>	\$57.88	
Outstanding at December 31, 2006 .....	<u>8,454,869</u>	\$53.00	<u>4,627,249</u>

All options were issued at the closing market price on the last trading day preceding the date of grant. Options were issued in 2006, 2005 and 2004 with initial vesting periods ranging from immediate to three years.

At December 31, 2006, there was \$21.8 million of total unrecognized compensation expense related to nonvested option awards which the Company expects to recognize over a weighted average period of 1.9 years.

The following table summarizes information about stock options exercised (in thousands of dollars):

	For the years ended December 31,		
	2006	2005	2004
Fair value of options exercised .....	\$ 18,152	\$ 20,668	\$ 22,395
Total intrinsic value of options exercised .....	38,906	31,577	29,807
Fair value of options vested .....	15,295	25,574	24,613
Cash received upon exercise of options .....	64,437	65,997	72,275
Tax benefit realized from exercise of options .....	14,936	11,962	12,068

Information about stock options outstanding and exercisable as of December 31, 2006, is as follows:

Range of Exercise Prices	Options Outstanding				Options Exercisable			
	Weighted Average				Weighted Average			
	Number	Remaining Contractual Life	Exercise Price	Intrinsic Value (000's)	Number	Remaining Contractual Life	Exercise Price	Intrinsic Value (000's)
\$30.88 – 44.91	1,913,226	3.83 Years	\$40.34	\$ 56,635	1,655,516	3.76 Years	\$40.78	\$ 48,277
\$45.50 – 51.69	1,906,787	4.86 Years	\$47.28	\$ 43,205	1,756,027	4.67 Years	\$47.21	\$ 39,916
\$52.29 – 54.45	1,951,196	7.78 Years	\$53.15	\$ 32,763	113,221	6.19 Years	\$53.56	\$ 1,855
\$54.61 – 76.61	2,683,660	7.57 Years	\$65.97	\$ 10,660	1,102,485	5.34 Years	\$54.70	\$ 16,799
	<u>8,454,869</u>	6.16 Years	\$53.00	<u>\$143,263</u>	<u>4,627,249</u>	4.54 Years	\$46.85	<u>\$106,847</u>

Effective January 1, 2006, the Company adopted a binomial lattice model for the valuation of stock options. The weighted average fair value of options granted in 2006, using a binomial lattice model, was \$18.91. The fair value of each option granted in 2006, based on a binomial lattice model, used the following assumptions:

	Year Ended December 31, 2006
Risk-free interest rate .....	4.9%
Expected life .....	6 years
Expected volatility .....	23.9%
Expected dividend yield .....	1.5%

The weighted average fair value of the stock options granted during 2005 and 2004 was \$13.36 and \$13.08, respectively. The fair value of each option estimated on the date of grant, based on a Black-Scholes valuation model, used the following assumptions:

	Year Ended December 31, 2005	Year Ended December 31, 2004
Risk-free interest rate .....	4.1%	4.1%
Expected life .....	7 years	7 years
Expected volatility .....	20.1%	20.1%
Expected dividend yield .....	1.8%	1.8%

The risk-free interest rate is selected based on yields from U.S. Treasury zero-coupon issues with a remaining term approximately equal to the expected term of the options being valued. The expected life selected for options granted during each year presented represents the period of time that the options are expected to be outstanding based on historical data of option holder exercise and termination behavior. Expected volatilities are based upon historical volatility of the Company's monthly stock closing prices over a period equal to the expected life of each option grant.

#### Performance Shares

On February 22, 2006, the Company awarded performance-based shares to certain executives. Receipt of Company stock is contingent upon the Company meeting sales growth and return on invested capital (ROIC) performance goals. Each participant was granted a base number of shares. At the end of the first year performance period, the number of shares granted will be increased, decreased or remain the same based upon actual Company-wide sales growth versus target sales growth. The shares, as determined at the end of the performance year (fiscal 2006), will be issued at the end of the third year (fiscal 2008) if the Company's average target ROIC is achieved for the fiscal period 2006 through 2008. The total number of shares earned for 2006 was 40,416. The amount expensed for the year ended December 31, 2006, was \$0.9 million, based upon the number of shares earned.

Performance share value is based upon closing market prices on the last trading day preceding the date of award and is charged to earnings on a straight-line basis over the three year period. Holders of performance shares are entitled to receive cash payments equivalent to cash dividends after the end of the first year performance period. If the performance shares vest, they will be settled by the issuance of Company common stock certificates in exchange for the performance shares on a one-for-one basis.

#### Restricted Stock

The plans authorize the granting of restricted stock, which is held by the Company pursuant to the terms and conditions related to the applicable grants. Except for the right of disposal, holders of restricted stock have full shareholders' rights during the period of restriction, including voting rights and the right to receive dividends. Restricted stock grants have original vesting periods of six to ten years.

Compensation expense related to restricted stock awards is based upon the closing market price on the last trading day preceding the date of grant and is charged to earnings on a straight-line basis over the vesting period. The following table summarizes the transactions involving restricted stock granted to employees:

	2006	2005	2004
Beginning nonvested shares outstanding.....	270,000	322,000	682,000
Issuances .....	—	—	10,000
Shares Converted to Restricted Stock Units .....	—	—	(215,000)
Cancellations.....	(10,000)	(5,000)	(5,000)
Vesting.....	(155,000)	(47,000)	(150,000)
Ending nonvested shares outstanding.....	105,000	270,000	322,000
Weighted average per share value of issuances .....	NA	NA	\$50.66
Fair value of shares vested .....	\$11.1 million	\$3.0 million	\$8.3 million
Restricted stock compensation expense .....	\$ 0.9 million	\$1.0 million	\$4.3 million

At December 31, 2006, there was \$0.9 million of total unrecognized compensation expense related to nonvested restricted stock which the Company expects to recognize over a weighted average period of 2.3 years.

#### Restricted Stock Units (RSUs)

Awards of RSUs are provided for under the stock compensation plans. RSUs granted to management vest over periods from three to seven years from issuance, although accelerated vesting is provided in certain instances. Holders of RSUs are entitled to receive cash payments equivalent to cash dividends and other distributions paid with respect to common stock. At various times after vesting, RSUs will be settled by the issuance of stock certificates evidencing the conversion of the RSUs into shares of the Company common stock on a one-for-one basis. Compensation expense related to RSUs is based upon the closing market prices on the last trading day preceding the date of award and is charged to earnings on a straight-line basis over the vesting period.

The following table summarizes RSUs activity granted to employees:

	2006		2005		2004	
	Shares	Weighted Average	Shares	Weighted Average	Shares	Weighted Average
Beginning nonvested units.....	517,000	\$49.74	369,800	\$47.70	—	—
Issuances .....	408,300	\$75.54	239,675	\$53.96	227,300	\$53.43
Restricted Stock converted to RSUs .....	—	—	—	—	215,000	\$43.68
Cancellations.....	(26,750)	\$66.84	(22,375)	\$52.25	(23,600)	\$53.32
Vestings .....	(74,550)	\$69.56	(70,100)	\$52.54	(48,900)	\$54.14
Ending nonvested units.....	824,000	\$60.18	517,000	\$49.74	369,800	\$47.70
RSUs compensation expense ..	\$12.0 million		\$7.9 million		\$4.7 million	

The total fair value of shares vested during 2006, 2005 and 2004, was \$5.2 million, \$3.7 million and \$2.6 million, respectively.

At December 31, 2006, there was \$33.7 million of total unrecognized compensation expense related to nonvested RSUs which the Company expects to recognize over a weighted average period of 4.8 years.

#### Director Stock Awards

The Company provides members of the Board of Directors with deferred stock unit grants. A stock unit is the economic equivalent of a share of common stock. The number of units covered by each grant is equal to \$60,000 divided by the fair market value of a share of common stock at the time of the grant, rounded up to the next ten-unit increment. The Company also awards stock units in connection with elective deferrals of director fees and dividend equivalents on existing stock units. Deferred fees and dividend equivalents on existing stock units are converted into stock units on the basis of the market value of the stock at the relevant times. Payment of the value of stock units is scheduled to be made after termination of service as a director. As of December 31, 2006, 2005 and 2004, there were eleven, ten and ten nonemployee directors who held stock units.

The Company recognizes income (expense) for the change in value of equivalent stock units. The following table summarizes activity for stock units related to deferred director fees (dollars in thousands):

	2006		2005		2004	
	Units	Dollars	Units	Dollars	Units	Dollars
Beginning Balance .....	51,977	\$ 3,696	39,398	\$ 2,625	39,506	\$ 1,872
Dividends .....	902	64	722	45	555	30
Deferred Fees .....	14,844	1,128	15,039	856	1,532	86
Retirement Distributions .....	(6,481)	(461)	(3,182)	(198)	(2,195)	(104)
Unit (Depreciation) / Appreciation .....	—	(144)	—	368	—	741
Ending Balance .....	<u>61,242</u>	<u>\$ 4,283</u>	<u>51,977</u>	<u>\$ 3,696</u>	<u>39,398</u>	<u>\$ 2,625</u>

In 2004, a retainer fee for board service was paid to nonemployee directors in the form of an annual award of unrestricted shares of common stock. The number of shares awarded was equal to the retainer fee divided by the fair market value of a share of common stock at the time of the award, rounded up to the next ten-share increment. Total shares granted were 5,510. The weighted average fair market value of these grants was \$54.54. In 2005, the Directors' retainer reverted to a cash basis.

### NOTE 13 – CAPITAL STOCK

The Company had no shares of preferred stock outstanding as of December 31, 2006, 2005 and 2004. The activity of outstanding common stock and common stock held in treasury was as follows:

	2006		2005		2004	
	Outstanding Common Stock	Treasury Stock	Outstanding Common Stock	Treasury Stock	Outstanding Common Stock	Treasury Stock
Balance at beginning of period ....	89,715,641	19,952,297	90,597,427	19,075,511	91,020,989	18,356,227
Exercise of stock options .....	1,390,461	(1,390,461)	1,503,259	(1,503,259)	1,825,085	(1,319,363)
Issuance and vesting of restricted stock, net of 59,297, 15,493 and 45,647 shares retained, respectively .....	(59,297)	59,297	(15,493)	15,493	(35,647)	45,647
Settlement of restricted stock units, net of 6,228, 3,017 and 1,015 shares retained, respectively .....	13,822	(13,822)	7,748	(7,748)	2,490	(2,490)
Cancellation of restricted shares .....	(10,000)	—	(5,000)	—	(5,000)	—
Conversion of restricted stock to restricted stock units .....	—	—	—	—	(215,000)	—
Purchase of treasury shares, net of 0, 0 and 5,510 shares issued, respectively .....	(6,983,000)	6,983,000	(2,372,300)	2,372,300	(1,995,490)	1,995,490
Balance at end of period .....	<u>84,067,627</u>	<u>25,590,311</u>	<u>89,715,641</u>	<u>19,952,297</u>	<u>90,597,427</u>	<u>19,075,511</u>

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**NOTE 14 – INCOME TAXES**

The Company accounts for income taxes under the provisions of SFAS No. 109, "Accounting for Income Taxes." SFAS No. 109 requires recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial reporting and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse.

Income tax expense consisted of (in thousands of dollars):

	For the Years Ended December 31,		
	2006	2005	2004
Current provision:			
Federal .....	\$172,961	\$134,194	\$135,391
State .....	31,725	27,517	24,815
Foreign .....	5,080	976	2,460
Total current.....	209,766	162,687	162,666
Deferred tax provision (benefit):			
Federal .....	8,996	17,575	(5,986)
State .....	1,636	3,298	(684)
Foreign .....	(774)	2,790	2,220
Total deferred .....	9,858	23,663	(4,450)
Total provision.....	<u>\$219,624</u>	<u>\$186,350</u>	<u>\$158,216</u>

The income tax effects of temporary differences that gave rise to the net deferred tax asset were (in thousands of dollars):

	As of December 31,		
	2006	2005	2004
Deferred tax assets:			
Inventory .....	\$ 13,809	\$ 28,817	\$ 37,927
Accrued expenses .....	28,606	30,463	31,219
Accrued employment-related benefits .....	99,006	71,446	65,760
Foreign operating loss carryforwards .....	9,530	9,272	9,616
Other .....	8,582	7,364	5,441
Deferred tax assets .....	159,533	147,362	149,963
Less valuation allowance .....	(13,461)	(10,872)	(10,265)
Deferred tax assets, net of valuation allowance.....	<u>\$146,072</u>	<u>\$136,490</u>	<u>\$139,698</u>
Deferred tax liabilities:			
Purchased tax benefits.....	\$ (7,715)	\$ (8,965)	\$ (10,090)
Property, buildings and equipment .....	(4,303)	(17,423)	(9,594)
Intangibles.....	(14,182)	(10,219)	—
Software.....	(10,627)	(7,177)	(623)
Prepays .....	(14,111)	(1,950)	—
Other.....	(4,453)	(4,599)	(8,073)
Deferred tax liabilities .....	<u>(55,391)</u>	<u>(50,333)</u>	<u>(28,380)</u>
Net deferred tax asset .....	<u>\$ 90,681</u>	<u>\$ 86,157</u>	<u>\$111,318</u>
The net deferred tax asset is classified as follows:			
Current assets .....	\$ 48,123	\$ 76,474	\$ 86,632
Noncurrent assets .....	48,793	16,702	29,168
Noncurrent liabilities (foreign) .....	(6,235)	(7,019)	(4,482)
Net deferred tax asset .....	<u>\$ 90,681</u>	<u>\$ 86,157</u>	<u>\$111,318</u>

At December 31, 2006, the Company had \$20.5 million of foreign operating loss carryforwards related to foreign operations, which begin to expire in 2008. The valuation allowance represents a provision for uncertainty as to the realization of the tax benefits of these carryforwards.

In addition, the Company recorded a valuation allowance to reflect the estimated amount of deferred tax assets that may not be realized due to capital loss limitations.

The purchased tax benefits represent lease agreements acquired in prior years under the provisions of the Economic Recovery Act of 1981.

The changes in the valuation allowance were as follows (in thousands of dollars):

	For the Years Ended December 31,		
	2006	2005	2004
Beginning balance .....	\$ 10,872	\$ 10,265	\$ 14,919
(Decrease) increase related to foreign net operating loss carryforwards.....	(70)	607	(632)
Unrealized (realized) capital losses .....	2,659	—	(4,022)
Ending balance .....	<u>\$ 13,461</u>	<u>\$ 10,872</u>	<u>\$ 10,265</u>

A reconciliation of income tax expense with federal income taxes at the statutory rate follows (in thousands of dollars):

	For the Years Ended December 31,		
	2006	2005	2004
Federal income tax at the statutory rate.....	\$211,058	\$186,436	\$155,799
State income taxes, net of federal income tax benefit .....	22,795	20,030	16,130
Resolution of prior year tax contingencies .....	(12,200)	(9,700)	(3,356)
Other – net.....	(2,029)	(10,416)	(10,357)
Income tax expense .....	<u>\$219,624</u>	<u>\$186,350</u>	<u>\$158,216</u>
Effective tax rate .....	<u>36.4%</u>	<u>35.0%</u>	<u>35.5%</u>

Undistributed earnings of foreign subsidiaries at December 31, 2006, amounted to \$1.3 million. No provision for deferred U.S. income taxes has been made for these subsidiaries because the Company intends to permanently reinvest such earnings in those foreign operations. Additionally, if such earnings were repatriated, U.S. taxes payable would be substantially eliminated by available tax credits arising from taxes paid outside of the United States.

The Company regularly undergoes examination of its federal income tax returns by the Internal Revenue Service (IRS). The Company and the IRS have settled tax years through 2003. Additionally, the Company is routinely involved in state and local income tax audits, and on occasion, foreign jurisdiction tax audits. The Company expects to resolve these audits within the amounts paid and/or reserved for these liabilities.

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**NOTE 15 – EARNINGS PER SHARE**

Basic earnings per share is based on the weighted average number of shares outstanding during the year. Diluted earnings per share is based on the combination of weighted average number of shares outstanding and dilutive potential shares. The Company had additional outstanding stock options of 1.36 million, 0.04 million and 2.68 million for the years ended December 31, 2006, 2005 and 2004, respectively, that were excluded from the computation of diluted earnings per share because the options' exercise price was greater than the average market price of the common stock.

The following table sets forth the computation of basic and diluted earnings per share:

	For the Years Ended December 31,		
	2006	2005	2004
	(In thousands, except for per share amounts)		
Net earnings .....	\$383,399	\$346,324	\$286,923
Denominator for basic earnings per share – weighted average shares .....	87,839	89,569	90,207
Effect of dilutive securities – stock-based compensation .....	2,685	2,019	1,466
Denominator for diluted earnings per share – weighted average shares adjusted for dilutive securities .....	90,524	91,588	91,673
Basic earnings per common share .....	\$ 4.36	\$ 3.87	\$ 3.18
Diluted earnings per common share .....	\$ 4.24	\$ 3.78	\$ 3.13

**NOTE 16 – PREFERRED SHARE PURCHASE RIGHTS**

The Company has a shareholder rights plan, under which there is outstanding one preferred share purchase right (Right) for each outstanding share of the Company's common stock. Each Right, under certain circumstances, may be exercised to purchase one one-hundredth of a share of Series A-1999 Junior Participating Preferred Stock (intended to be the economic equivalent of one share of the Company's common stock) at a price of \$250.00, subject to adjustment. The Rights become exercisable only after a person or a group, other than a person or group exempt under the plan, acquires or announces a tender offer for 15% or more of the Company's common stock. If a person or group, other than a person or group exempt under the plan, acquires 15% or more of the Company's common stock or if the Company is acquired in a merger or other business combination transaction, each Right generally entitles the holder, other than such person or group, to purchase, at the then-current exercise price, stock and/or other securities or assets of the Company or the acquiring company having a market value of twice the exercise price.

The Rights expire on May 15, 2009, unless earlier redeemed. They generally are redeemable at \$.001 per Right until thirty days following announcement that a person or group, other than a person or group exempt under the plan, has acquired 15% or more of the Company's common stock. The Rights do not have voting or dividend rights and, until they become exercisable, have no dilutive effect on the earnings of the Company.

**NOTE 17 – SEGMENT INFORMATION**

Effective January 1, 2006, Grainger revised its segment disclosure. Acklands – Grainger, which had previously been included in Branch-based Distribution, is now being reported as a separate segment. Operations are managed and reported in three segments. The three reportable segments are Grainger Branch-based, Acklands – Grainger Branch-based and Lab Safety. Prior year segment amounts have been restated to maintain comparability. Grainger Branch-based is an aggregation of the following business units: Grainger Industrial Supply, Grainger, S.A. de C.V. (Mexico), Grainger Caribe Inc. (Puerto Rico) and Grainger China LLC (China). Acklands – Grainger is the Company's Canadian branch-based distribution business. Lab Safety is a direct marketer of safety and other industrial products.

The Company's branch-based segments offer similar services and products while the Lab Safety segment offers differing ranges of services and products and requires different resources and marketing strategies. The accounting policies of the segments are the same as those described in the summary of significant accounting policies. Intersegment transfer prices are established at external selling prices, less costs not incurred due to a related party sale.

The following segment information has been modified for all periods presented in order to conform to the new presentation (in thousands of dollars).

	2006			
	Grainger Branch-based	Acklands – Grainger Branch-based	Lab Safety	Total
Total net sales.....	\$4,910,836	\$565,098	\$411,511	\$5,887,445
Intersegment net sales.....	(1,214)	—	(2,577)	(3,791)
Net sales to external customers.....	4,909,622	565,098	408,934	5,883,654
Segment operating earnings.....	593,455	15,242	52,283	660,980
Segment assets.....	1,938,270	394,707	215,515	2,548,492
Depreciation and amortization.....	88,753	9,505	8,099	106,357
Additions to long-lived assets.....	\$ 112,414	\$ 8,238	\$ 37,733	\$ 158,385
	2005			
	Grainger Branch-based	Acklands – Grainger Branch-based	Lab Safety	Total
Total net sales.....	\$4,649,200	\$502,021	\$380,091	\$5,531,312
Intersegment net sales.....	(2,125)	—	(2,551)	(4,676)
Net sales to external customers.....	4,647,075	502,021	377,540	5,526,636
Segment operating earnings.....	522,635	14,003	52,712	589,350
Segment assets.....	1,821,897	389,855	175,201	2,386,953
Depreciation and amortization.....	80,994	7,638	7,756	96,388
Additions to long-lived assets.....	\$ 129,326	\$ 17,405	\$ 27,107	\$ 173,838
	2004			
	Grainger Branch-based	Acklands – Grainger Branch-based	Lab Safety	Total
Total net sales.....	\$4,283,272	\$434,258	\$336,720	\$5,054,250
Intersegment net sales.....	(2,387)	—	(2,078)	(4,465)
Net sales to external customers.....	4,280,885	434,258	334,642	5,049,785
Segment operating earnings.....	444,574	20,967	45,467	511,008
Segment assets.....	1,667,862	366,779	144,471	2,179,112
Depreciation and amortization.....	70,490	5,118	7,870	83,478
Additions to long-lived assets.....	\$ 138,457	\$ 16,709	\$ 2,910	\$ 158,076

Following are reconciliations of the segment information with the consolidated totals per the financial statements (in thousands of dollars):

	2006	2005	2004
Operating earnings:			
Total operating earnings for reportable segments.....	\$ 660,980	\$ 589,350	\$ 511,008
Unallocated expenses.....	(82,909)	(70,361)	(69,754)
Total consolidated operating earnings.....	<u>\$ 578,071</u>	<u>\$ 518,989</u>	<u>\$ 441,254</u>
Assets:			
Total assets for reportable segments.....	\$2,548,492	\$2,386,953	\$2,179,112
Unallocated assets.....	497,596	720,968	630,461
Total consolidated assets.....	<u>\$3,046,088</u>	<u>\$3,107,921</u>	<u>\$2,809,573</u>

	2006		
	Segment Totals	Unallocated	Consolidated Total
Other significant items:			
Depreciation and amortization .....	\$ 106,357	\$ 12,211	\$ 118,568
Additions to long-lived assets .....	\$ 158,385	\$ 14,268	\$ 172,653
		Revenues	Long-Lived Assets
Geographic information:			
United States .....		\$5,197,240	\$ 909,188
Canada .....		567,626	176,097
Other foreign countries .....		118,788	8,784
		<u>\$5,883,654</u>	<u>\$1,094,069</u>
	2005		
	Segment Totals	Unallocated	Consolidated Total
Other significant items:			
Depreciation and amortization .....	\$ 96,388	\$ 12,394	\$ 108,782
Additions to long-lived assets .....	\$ 173,838	\$ 5,528	\$ 179,366
		Revenues	Long-Lived Assets
Geographic information:			
United States .....		\$4,897,309	\$ 864,154
Canada .....		504,373	178,609
Other foreign countries .....		124,954	4,610
		<u>\$5,526,636</u>	<u>\$1,047,373</u>
	2004		
	Segment Totals	Unallocated	Consolidated Total
Other significant items:			
Depreciation and amortization .....	\$ 83,478	\$ 14,778	\$ 98,256
Additions to long-lived assets .....	\$ 158,076	\$ 2,682	\$ 160,758
		Revenues	Long-Lived Assets
Geographic information:			
United States .....		\$4,507,030	\$ 808,564
Canada .....		436,877	165,240
Other foreign countries .....		105,878	4,236
		<u>\$5,049,785</u>	<u>\$ 978,040</u>

Long-lived assets consist of property, buildings, equipment, capitalized software, goodwill and other intangibles.

Revenues are attributed to countries based on the ship-to location of the customer.

Unallocated expenses and unallocated assets primarily relate to the Company headquarters' support services, which are not part of any business segment. Unallocated expenses include payroll and benefits, depreciation and other costs associated with headquarters-related support services. Unallocated assets include nonoperating cash and cash equivalents, certain prepaid expenses and property, buildings and equipment – net.

Unallocated expenses increased \$12.5 million in the year ended December 31, 2006, when compared with the prior year primarily due to increases in payroll and benefits at headquarters driven by stock-based compensation related to the adoption of SFAS No. 123R. Unallocated assets decreased \$223.4 million in the year ended December 31, 2006, when compared with the prior year primarily due to a lower cash balance.

The change in the carrying amount of goodwill by segment from January 1, 2004 to December 31, 2006, is as follows:

Goodwill, net by Segment	Acklands – Grainger		Total
	Branch-based	Lab Safety	
Balance at January 1, 2004 .....	\$108,341	\$ 47,928	\$156,269
Translation .....	8,742	—	8,742
Balance at December 31, 2004 .....	117,083	47,928	165,011
Acquisition .....	—	14,019	14,019
Translation .....	3,696	—	3,696
Balance at December 31, 2005 .....	120,779	61,947	182,726
Acquisitions .....	—	28,276	28,276
Translation .....	(331)	—	(331)
Balance at December 31, 2006 .....	<u>\$120,448</u>	<u>\$ 90,223</u>	<u>\$210,671</u>

#### NOTE 18 – SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

A summary of selected quarterly information for 2006 and 2005 is as follows:

	2006 Quarter Ended				
	(In thousands of dollars, except for per share amounts)				
	March 31	June 30	September 30	December 31	Total
Net sales .....	\$1,419,117	\$1,482,880	\$1,519,499	\$1,462,158	\$5,883,654
Cost of merchandise sold .....	848,790	899,575	920,412	860,727	3,529,504
Gross profit .....	570,327	583,305	599,087	601,431	2,354,150
Warehousing, marketing and administrative expenses .....	435,910	438,761	447,774	453,634	1,776,079
Operating earnings .....	134,417	144,544	151,313	147,797	578,071
Net earnings .....	86,233	93,739	104,494	98,933	383,399
Earnings per share – basic .....	0.96	1.05	1.20	1.15	4.36
Earnings per share – diluted .....	\$ 0.93	\$ 1.02	\$ 1.16	\$ 1.13	\$ 4.24

  

	2005 Quarter Ended				
	(In thousands of dollars, except for per share amounts)				
	March 31	June 30	September 30	December 31	Total
Net sales .....	\$1,334,880	\$1,372,808	\$1,428,342	\$1,390,606	\$5,526,636
Cost of merchandise sold .....	836,004	845,679	880,180	803,232	3,365,095
Gross profit .....	498,876	527,129	548,162	587,374	2,161,541
Warehousing, marketing and administrative expenses .....	385,919	400,936	412,280	443,417	1,642,552
Operating earnings .....	112,957	126,193	135,882	143,957	518,989
Net earnings .....	72,792	81,589	88,109	103,834	346,324
Earnings per share – basic .....	0.81	0.91	0.98	1.17	3.87
Earnings per share – diluted .....	\$ 0.79	\$ 0.89	\$ 0.97	\$ 1.13	\$ 3.78

The 2006 fourth quarter included a \$0.06 per share benefit from a reduction of deferred tax liabilities related to property, buildings and equipment. The 2006 third quarter included a \$0.09 per share benefit from the resolution of uncertainties related to the audit of the 2004 tax year.

In the fourth quarter of 2005, the gross profit margins were higher than the first three quarters. This primarily related to favorable inventory adjustments from fourth quarter physicals (\$18.6 million) and favorable adjustments related to the year-end LIFO calculations (\$9.5 million). Due to the improved methodology to capture data related to certain inventory transactions and estimates, these types of adjustments were spread throughout the year in 2006 as opposed to being recorded in the fourth quarter.

In the fourth quarter of 2005, the Company reduced its income tax rate for the year to 35.0% from its previous projection of 37.0%. This reduction was primarily due to the recognition of tax benefits related to a favorable revision to the estimate of income taxes for various state and local taxing jurisdictions and the resolution of federal and state tax contingencies. The reduction was not determinable until the fourth quarter when these items were finalized and their effect on the rate quantified.

#### **NOTE 19 – UNCLASSIFIED – NET**

The components of Unclassified – net were as follows (in thousands of dollars):

	For the Years Ended December 31,		
	2006	2005	2004
Income items .....	\$ 359	\$ 25	\$ 384
Expense items .....	(228)	(168)	(233)
Unclassified – net .....	<u>\$ 131</u>	<u>\$ (143)</u>	<u>\$ 151</u>

#### **NOTE 20 – CONTINGENCIES AND LEGAL MATTERS**

The Company has an outstanding guarantee relating to an industrial revenue bond assumed by the buyer of one of the Company's formerly owned facilities. The maximum exposure under this guarantee is \$8.5 million and it expires on December 15, 2008. The Company has not recorded any liability relating to this guarantee and believes it is unlikely that material payments will be required.

The Company has been named, along with numerous other nonaffiliated companies, as a defendant in litigation in various states involving asbestos and/or silica. These lawsuits typically assert claims of personal injury arising from alleged exposure to asbestos and/or silica as a consequence of products purportedly distributed by the Company. As of January 17, 2007, the Company is named in cases filed on behalf of approximately 3,100 plaintiffs in which there is an allegation of exposure to asbestos and/or silica. In addition, five cases alleging exposure to cotton dust were amended during 2004 to add allegations relating to asbestos, but during 2006 the pleadings in those cases were amended and no longer contain allegations of asbestos exposure.

The Company has denied, or intends to deny, the allegations in all of the above-described lawsuits. In 2006, lawsuits relating to asbestos and/or silica and involving approximately 300 plaintiffs were dismissed with respect to the Company, typically based on the lack of product identification. If a specific product distributed by the Company is identified in any of these lawsuits, the Company would attempt to exercise indemnification remedies against the product manufacturer. In addition, the Company believes that a substantial number of these claims are covered by insurance. The Company is engaged in active discussions with its insurance carriers regarding the scope and amount of coverage. While the Company is unable to predict the outcome of these lawsuits, it believes that the ultimate resolution will not have, either individually or in the aggregate, a material adverse effect on the Company's consolidated financial position or results of operations.

In addition to the foregoing, from time to time the Company is involved in various other legal and administrative proceedings that are incidental to its business, including claims relating to product liability, general negligence, environmental issues, employment, intellectual property and other matters. As a government contractor, from time to time the Company is also subject to governmental or regulatory inquiries or audits, including current inquiries relating to pricing compliance and Trade Agreement Act compliance. It is not expected that the ultimate resolution of any of these matters will have, either individually or in the aggregate, a material adverse effect on the Company's consolidated financial position or results of operations.

## COMPUTATIONS OF EARNINGS PER SHARE

	2006	2005	2004
<b>BASIC:</b>			
Weighted average number of shares outstanding during the year.....	87,838,723	89,568,746	90,206,773
Net earnings .....	\$383,399,000	\$346,324,000	\$286,923,000
Earnings per share .....	\$ 4.36	\$ 3.87	\$ 3.18
<b>DILUTED:</b>			
Weighted average number of shares outstanding during the year.....	87,838,723	89,568,746	90,206,773
Potential shares:			
Shares issuable under common stock equivalents.....	8,976,453	10,087,382	8,445,302
Shares which could have been purchased using the proceeds from the common stock equivalents exercised, based on the average market value for the year .....	(6,330,180)	(8,106,909)	(7,015,367)
	2,646,273	1,980,473	1,429,935
Dilutive effect of exercised options prior to being exercised .....	38,778	39,076	36,667
	2,685,051	2,019,549	1,466,602
Adjusted weighted average number of shares outstanding during the year .....	90,523,774	91,588,295	91,673,375
Net earnings .....	\$383,399,000	\$346,324,000	\$286,923,000
Earnings per share .....	\$ 4.24	\$ 3.78	\$ 3.13

We consent to the incorporation by reference in the Registration Statements (Form S-8 No.'s 33-43902, 333-24215, 333-61980, 333-105185, 333-124356 and Form S-4 No. 33-32091) of W.W. Grainger, Inc. and in the related prospectuses of our report dated February 26, 2007, with respect to the consolidated financial statements of W.W. Grainger, Inc., W.W. Grainger, Inc. management's assessment of the effectiveness of internal control over financial reporting, and the effectiveness of internal control over financial reporting of W.W. Grainger, Inc., included in this Annual Report (Form 10-K) for the year ended December 31, 2006.

ERNST & YOUNG LLP

Chicago, Illinois  
February 26, 2007

We hereby consent to the incorporation of our report dated February 11, 2005, accompanying the consolidated financial statements on page 29 of the Annual Report for the year ended December 31, 2004, by reference in the prospectuses constituting part of the Registration Statements on Form S-8 (Nos. 33-43902, 333-24215, 333-61980, 333-105185 and 333-123456) and on Form S-4 (No. 33-32091) of W.W. Grainger, Inc.

GRANT THORNTON LLP

Chicago, Illinois  
February 26, 2007

I, R. L. Keyser, certify that:

1. I have reviewed this Annual Report on Form 10-K of W.W. Grainger, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 23, 2007

By: R. L. Keyser

Name: R. L. Keyser

Title: Chairman and Chief Executive Officer

I, P. O. Loux, certify that:

1. I have reviewed this Annual Report on Form 10-K of W.W. Grainger, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 23, 2007

By: P. O. Loux

Name: P. O. Loux

Title: Senior Vice President, Finance  
and Chief Financial Officer

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**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

EXHIBIT 32(a)

I, R. L. Keyser, Chairman and Chief Executive Officer of W.W. Grainger, Inc. ("Grainger"), certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Annual Report on Form 10-K of Grainger for the annual period ended December 31, 2006, (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Grainger.

R. L. Keyser

R. L. Keyser  
Chairman and Chief Executive Officer

February 23, 2007

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**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

EXHIBIT 32(b)

I, P. O. Loux, Senior Vice President, Finance and Chief Financial Officer of W.W. Grainger, Inc. ("Grainger"), certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Annual Report on Form 10-K of Grainger for the annual period ended December 31, 2006, (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Grainger.

P. O. Loux

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P. O. Loux

Senior Vice President, Finance  
and Chief Financial Officer

February 23, 2007