
INDEX TO FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

December 31, 2004, 2003 and 2002

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Shareholders and Board of Directors
W.W. Grainger, Inc.

We have audited the accompanying consolidated balance sheets of W.W. Grainger, Inc., and Subsidiaries as of December 31, 2004, 2003 and 2002, and the related consolidated statements of earnings, comprehensive earnings, shareholders' equity, and cash flows for the three years then ended. We have also audited management's assessment, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting, that W.W. Grainger, Inc., and Subsidiaries maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). W.W. Grainger, Inc.'s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and the receipts and expenditures of the company are being made only in accordance with authorization of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W.W. Grainger, Inc., and Subsidiaries as of December 31, 2004, 2003 and 2002, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment that W.W. Grainger, Inc. and Subsidiaries maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Furthermore, in our opinion, W.W. Grainger, Inc., and Subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

As discussed in Note 3, effective January 1, 2002, the Company changed its method of accounting for goodwill and other intangible assets upon adoption of Statement of Financial Accounting Standards (SFAS) No. 142, "Goodwill and Other Intangible Assets."

GRANT THORNTON LLP

Chicago, Illinois
February 11, 2005

W.W. Grainger, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF EARNINGS

(In thousands of dollars, except for per share amounts)

	For the Years Ended December 31,		
	2004	2003	2002
Net sales	\$5,049,785	\$4,667,014	\$4,643,898
Cost of merchandise sold	<u>3,143,133</u>	<u>2,975,513</u>	<u>2,984,548</u>
Gross profit	<u>1,906,652</u>	<u>1,691,501</u>	<u>1,659,350</u>
Warehousing, marketing and administrative expenses	1,467,348	1,304,804	1,268,134
Restructuring charge	(226)	(564)	(1,939)
Total operating expenses	<u>1,467,122</u>	<u>1,304,240</u>	<u>1,266,195</u>
Operating earnings	439,530	387,261	393,155
Other income and (expense):			
Interest income	6,376	3,347	4,573
Interest expense	(4,388)	(6,015)	(6,163)
Equity in income (loss) of unconsolidated entities – net.....	996	(2,288)	(3,025)
Write-off of investments in unconsolidated entities	—	(1,921)	—
Gain on sale of unconsolidated entity	750	—	—
Unclassified – net	<u>1,875</u>	<u>706</u>	<u>9,297</u>
Total other income and (expense)	<u>5,609</u>	<u>(6,171)</u>	<u>4,682</u>
Earnings before income taxes and cumulative effect of accounting change	445,139	381,090	397,837
Income taxes	<u>158,216</u>	<u>154,119</u>	<u>162,349</u>
Earnings before cumulative effect of accounting change	286,923	226,971	235,488
Cumulative effect of accounting change	—	—	(23,921)
Net earnings	<u>\$ 286,923</u>	<u>\$ 226,971</u>	<u>\$ 211,567</u>
Earnings per share before cumulative effect of accounting change:			
Basic	<u>\$ 3.18</u>	<u>\$ 2.50</u>	<u>\$ 2.56</u>
Diluted.....	<u>\$ 3.13</u>	<u>\$ 2.46</u>	<u>\$ 2.50</u>
Cumulative effect of accounting change:			
Basic	<u>\$ —</u>	<u>\$ —</u>	<u>\$ (0.26)</u>
Diluted.....	<u>\$ —</u>	<u>\$ —</u>	<u>\$ (0.26)</u>
Earnings per share:			
Basic	<u>\$ 3.18</u>	<u>\$ 2.50</u>	<u>\$ 2.30</u>
Diluted.....	<u>\$ 3.13</u>	<u>\$ 2.46</u>	<u>\$ 2.24</u>
Weighted average number of shares outstanding:			
Basic	<u>90,206,773</u>	<u>90,731,013</u>	<u>91,982,430</u>
Diluted.....	<u>91,673,375</u>	<u>92,394,085</u>	<u>94,303,497</u>

The accompanying notes are an integral part of these financial statements.

W.W. Grainger, Inc. and Subsidiaries**CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS**

(In thousands of dollars)

	For the Years Ended December 31,		
	2004	2003	2002
Net earnings	\$286,923	\$226,971	\$211,567
Other comprehensive earnings (losses):			
Foreign currency translation adjustments, net of tax (expense) benefit of \$(8,734), \$9,527 and \$551, respectively	15,458	37,600	(170)
Gains (losses) on investment securities:			
Unrealized holding gains (losses), net of tax (expense) benefit of \$0, \$(312) and \$1,523, respectively	—	488	(2,383)
Reclassifications for net losses (gains) included in earnings, net of tax (benefit) expense of \$0, \$(158) and \$2,325, respectively	—	248	(3,636)
	<u>15,458</u>	<u>38,336</u>	<u>(6,189)</u>
Comprehensive earnings.....	<u>\$302,381</u>	<u>\$265,307</u>	<u>\$205,378</u>

The accompanying notes are an integral part of these financial statements.

W.W. Grainger, Inc. and Subsidiaries

CONSOLIDATED BALANCE SHEETS

(In thousands of dollars, except for per share amounts)

ASSETS	As of December 31,		
	2004	2003	2002
CURRENT ASSETS			
Cash and cash equivalents	\$ 429,246	\$ 402,824	\$ 208,528
Accounts receivable (less allowances for doubtful accounts of \$23,375, \$24,736 and \$26,868, respectively)	480,893	431,896	423,240
Inventories	700,559	661,247	721,178
Prepaid expenses and other assets	47,086	37,947	36,665
Deferred income taxes	96,929	99,499	95,336
Total current assets	1,754,713	1,633,413	1,484,947
PROPERTY, BUILDINGS AND EQUIPMENT			
Land	154,673	153,357	154,065
Buildings, structures and improvements	804,317	785,890	769,124
Furniture, fixtures, machinery and equipment	679,141	605,903	569,669
	1,638,131	1,545,150	1,492,858
Less accumulated depreciation and amortization	876,558	813,158	756,051
Property, buildings and equipment – net	761,573	731,992	736,807
DEFERRED INCOME TAXES	18,871	20,296	20,541
INVESTMENTS IN UNCONSOLIDATED ENTITIES	26,126	22,822	15,988
OTHER ASSETS			
Goodwill – net	165,011	156,269	114,428
Customer lists and other intangibles	102,806	102,635	93,644
Less accumulated amortization	93,239	91,198	89,377
	9,567	11,437	4,267
Investments	—	—	5,315
Capitalized software – net	41,889	20,772	30,247
Sundry	31,823	27,677	24,908
Other assets – net	248,290	216,155	179,165
TOTAL ASSETS	\$2,809,573	\$2,624,678	\$2,437,448

W.W. Grainger, Inc. and Subsidiaries

CONSOLIDATED BALANCE SHEETS – CONTINUED

(In thousands of dollars, except for per share amounts)

LIABILITIES AND SHAREHOLDERS' EQUITY	As of December 31,		
	2004	2003	2002
CURRENT LIABILITIES			
Short-term debt.....	\$ —	\$ —	\$ 2,967
Current maturities of long-term debt.....	9,485	144,135	6,505
Trade accounts payable.....	289,388	257,806	290,807
Accrued compensation and benefits.....	121,497	98,422	84,000
Accrued contributions to employees' profit sharing plans.....	86,742	58,100	62,982
Accrued expenses.....	120,069	104,487	101,103
Income taxes.....	<u>35,253</u>	<u>43,690</u>	<u>37,902</u>
Total current liabilities.....	662,434	706,640	586,266
LONG-TERM DEBT (less current maturities).....	—	4,895	119,693
DEFERRED INCOME TAXES.....	4,482	—	—
ACCRUED EMPLOYMENT-RELATED BENEFITS COSTS.....	74,687	68,008	63,791
SHAREHOLDERS' EQUITY			
Cumulative Preferred Stock – \$5 par value – 12,000,000 shares authorized; none issued nor outstanding.....	—	—	—
Common Stock – \$0.50 par value – 300,000,000 shares authorized; issued, 109,672,938, 109,377,216 and 109,017,642 shares, respectively.....	54,836	54,689	54,509
Additional contributed capital.....	432,171	394,409	379,942
Retained earnings.....	2,458,442	2,242,762	2,083,072
Unearned restricted stock compensation.....	(14,463)	(11,471)	(17,144)
Accumulated other comprehensive earnings (losses).....	18,052	2,594	(35,742)
Treasury stock, at cost – 19,075,511, 18,356,227 and 17,449,587 shares, respectively.....	<u>(881,068)</u>	<u>(837,848)</u>	<u>(796,939)</u>
Total shareholders' equity.....	<u>2,067,970</u>	<u>1,845,135</u>	<u>1,667,698</u>
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY.....	<u><u>\$2,809,573</u></u>	<u><u>\$2,624,678</u></u>	<u><u>\$2,437,448</u></u>

The accompanying notes are an integral part of these financial statements.

W.W. Grainger, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands of dollars)

	For the Years Ended December 31,		
	2004	2003	2002
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net earnings	\$ 286,923	\$ 226,971	\$ 211,567
Provision for losses on accounts receivable	5,159	9,263	13,328
Deferred income taxes	(4,450)	5,382	(6,480)
Depreciation and amortization:			
Property, buildings and equipment	85,566	74,583	75,226
Capitalized software and other intangibles	12,690	15,670	18,262
Tax benefit of stock incentive plans	12,068	2,091	5,897
Gains on sales of investment securities	(50)	(1,208)	(7,308)
Net gains on sales of property, buildings and equipment	(1,725)	(1,607)	(5,219)
(Income) losses and write-off of unconsolidated entities ...	(996)	4,209	3,025
Cumulative effect of accounting change	—	—	23,921
Change in operating assets and liabilities – net of business acquisition and joint venture contributions:			
(Increase) decrease in accounts receivable	(49,935)	(7,194)	14,514
(Increase) decrease in inventories	(30,728)	83,530	(97,297)
(Increase) in prepaid expenses	(9,087)	(7)	(72)
Increase (decrease) in trade accounts payable	29,302	(37,420)	14,801
Increase (decrease) in other current liabilities	66,305	9,307	(867)
Increase (decrease) in current income taxes payable	(4,268)	3,333	27,824
Increase in accrued employment-related benefits costs	6,679	4,217	7,086
Other – net	3,034	2,988	5,262
Net cash provided by operating activities	406,487	394,108	303,470
CASH FLOWS FROM INVESTING ACTIVITIES:			
Additions to property, buildings and equipment	(128,276)	(74,064)	(133,978)
Proceeds from sales of property, buildings and equipment – net	17,616	12,144	16,158
Additions to capitalized software	(32,482)	(6,422)	(10,047)
Proceeds from sales of investment securities	50	6,115	15,957
Net cash paid for business acquisition	—	(36,713)	—
(Investments in and loans to) unconsolidated entities – net of distributions	—	(8,241)	5,748
Other – net	700	1,900	404
Net cash used in investing activities	(142,392)	(105,281)	(105,758)

W.W. Grainger, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF CASH FLOWS – CONTINUED

(In thousands of dollars)

	For the Years Ended December 31,		
	2004	2003	2002
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net decrease in short-term debt	\$ —	\$ (2,967)	\$ (2,830)
Long-term debt payments	(140,800)	(1,915)	(119,760)
Long-term debt issuance	—	318	113,810
Stock options exercised	72,275	15,171	17,076
Purchase of treasury stock – net	(100,872)	(41,204)	(99,882)
Cash dividends paid.....	(71,243)	(67,281)	(66,467)
	(240,640)	(97,878)	(158,053)
Exchange rate effect on cash and cash equivalents	2,967	3,347	23
NET INCREASE IN CASH AND CASH EQUIVALENTS.....	26,422	194,296	39,682
Cash and cash equivalents at beginning of year	402,824	208,528	168,846
Cash and cash equivalents at end of year	\$ 429,246	\$ 402,824	\$ 208,528
Supplemental cash flow information:			
Cash payments for interest (net of amounts capitalized)	\$ 3,408	\$ 6,082	\$ 7,197
Cash payments for income taxes	154,589	144,025	133,975
Noncash investing activities:			
Fair value of noncash assets acquired in business acquisition	\$ —	\$ 37,381	\$ —
Liabilities assumed in business acquisition.....	—	(668)	—
Increase (decrease) in fair value of investment securities, net of tax	—	736	(6,019)
Investment in unconsolidated entity	—	—	19,618

The accompanying notes are an integral part of these financial statements.

W.W. Grainger, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(In thousands of dollars, except for per share amounts)

	Common Stock	Additional Contributed Capital	Retained Earnings	Unearned Restricted Stock Compensation	Accumulated Other Comprehensive Earnings (Losses)	Treasury Stock
Balance at January 1, 2002.....	\$54,237	\$289,201	\$1,937,972	\$(17,722)	\$(29,553)	\$(630,946)
Exercise of stock options	291	16,739	—	—	—	46
Tax benefits on stock options exercised	—	5,647	—	—	—	—
Issuance of other stock-based compensation awards	37	4,631	—	(6,327)	—	—
Tax benefits on other vested stock-based compensation awards ...	—	250	—	—	—	—
Conversion of restricted stock to restricted stock units.....	(48)	48	—	—	—	—
Remeasurement of other stock-based compensation awards ...	—	132	—	—	—	—
Cancellation of other stock-based compensation awards ...	(8)	(1,017)	—	507	—	—
Amortization of unearned compensation on other stock-based compensation awards	—	—	—	6,398	—	—
Purchase of 4,801,600 shares of stock, net of 4,695,725 shares transferred in connection with related party transaction.....	—	64,267	—	—	—	(66,113)
Purchase of 2,221,500 shares of treasury stock; 5,850 shares issued ...	—	44	—	—	—	(99,926)
Other comprehensive (losses) earnings	—	—	—	—	(6,189)	—
Net earnings	—	—	211,567	—	—	—
Cash dividends paid (\$0.715 per share)	—	—	(66,467)	—	—	—
Balance at December 31, 2002	<u>\$54,509</u>	<u>\$379,942</u>	<u>\$2,083,072</u>	<u>\$(17,144)</u>	<u>\$(35,742)</u>	<u>\$(796,939)</u>
Exercise of stock options	205	14,726	—	—	—	250
Tax benefits on stock options exercised	—	1,855	—	—	—	—
Issuance of other stock-based compensation awards	(5)	(448)	—	(1,083)	—	—
Tax benefits on other vested stock-based compensation awards ...	—	236	—	—	—	—
Remeasurement of other stock-based compensation awards ...	—	129	—	—	—	—
Cancellation of other stock-based compensation awards ...	(20)	(1,986)	—	2,005	—	—
Amortization of unearned compensation on other stock-based compensation awards	—	—	—	4,751	—	—
Purchase of 918,300 shares of treasury stock; 6,160 shares issued ...	—	(45)	—	—	—	(41,159)
Other comprehensive earnings (losses)	—	—	—	—	38,336	—
Net earnings	—	—	226,971	—	—	—
Cash dividends paid (\$0.735 per share)	—	—	(67,281)	—	—	—
Balance at December 31, 2003	<u>\$54,689</u>	<u>\$394,409</u>	<u>\$2,242,762</u>	<u>\$(11,471)</u>	<u>\$ 2,594</u>	<u>\$(837,848)</u>

W.W. Grainger, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY – CONTINUED

(In thousands of dollars, except for per share amounts)

	<u>Common Stock</u>	<u>Additional Contributed Capital</u>	<u>Retained Earnings</u>	<u>Unearned Restricted Stock Compensation</u>	<u>Accumulated Other Comprehensive Earnings (Losses)</u>	<u>Treasury Stock</u>
Balance at December 31, 2003	\$54,689	\$394,409	\$2,242,762	\$(11,471)	\$ 2,594	\$(837,848)
Exercise of stock options	253	11,910	—	—	—	60,112
Tax benefits on stock options exercised	—	10,138	—	—	—	—
Issuance of other stock-based compensation awards	5	12,647	—	(12,652)	—	—
Tax benefits on other vested stock-based compensation awards ...	—	1,930	—	—	—	—
Conversion of restricted stock to restricted stock units.....	(108)	108	—	—	—	—
Remeasurement of stock options and other stock-based compensation awards	—	2,620	—	(809)	—	—
Cancellation of other stock-based compensation awards ...	(3)	(1,479)	—	1,482	—	—
Amortization of unearned compensation on other stock-based compensation awards	—	—	—	8,987	—	—
Settlement of other stock-based compensation awards ...	—	(161)	—	—	—	(2,411)
Purchase of 2,001,000 shares of treasury stock; 5,510 shares issued ...	—	49	—	—	—	(100,921)
Other comprehensive earnings (losses)	—	—	—	—	15,458	—
Net earnings	—	—	286,923	—	—	—
Cash dividends paid (\$0.785 per share)	—	—	(71,243)	—	—	—
Balance at December 31, 2004	<u>\$54,836</u>	<u>\$432,171</u>	<u>\$2,458,442</u>	<u>\$(14,463)</u>	<u>\$ 18,052</u>	<u>\$(881,068)</u>

The accompanying notes are an integral part of these financial statements.