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

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2004, 2003 and 2002

#### **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 assets and liabilities, and revenues and expenses. Actual results could differ from those estimates.

##### RECLASSIFICATIONS

Certain amounts in the 2003 and 2002 financial statements, as previously reported, have been reclassified to conform to the 2004 presentation.

##### 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. The Company also accounts for investments below 20% using the equity method when significant influence can be exercised over the operating and financial policies of the investee company. See Note 9 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 Emerging Issues Task Force (EITF) issued "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor" (Issue 02-16) in November 2002 with transition provisions subsequently issued in January 2003. The January 2003 transition rules stated that Issue 02-16 would apply to all agreements entered into or significantly modified after December 31, 2002. The Company's accounting treatment for vendor provided funds was consistent with Issue 02-16, with the exception of vendor funded advertising allowances. The Company had previously accounted for these allowances as an offset to operating (advertising) expenses. Under Issue 02-16, this method is allowable if the allowances are for specific, identifiable and incremental costs incurred by the Company in marketing its vendors' products. 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. This change does not have any effect on net earnings.

For 2004, as new vendor contracts became effective, most vendor allowances were classified in cost of merchandise sold rather than in operating (advertising) expenses. The Company has made reclassifications to the prior periods to maintain comparability. As a result, cost of merchandise sold was reduced and operating (advertising) expenses were increased by \$53.4 million and \$61.1 million for the years ended December 31, 2003 and 2002, respectively.

#### 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

The Company maintains various stock incentive plans. See Note 16 to the Consolidated Financial Statements. The Company accounts for these plans under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. The Company recognizes compensation cost for restricted shares and restricted stock units granted to employees. No compensation cost is recognized for stock option grants. All options granted under the Company's plans have an exercise price equal to the closing market price of the underlying common stock on the last trading day preceding the date of grant. The following table illustrates the effect on net earnings and earnings per share if the Company had applied the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation," to stock-based compensation. The following table also provides the amount of stock-based compensation cost included in net earnings as reported:

	For the Years Ended December 31,		
	2004	2003	2002
	(In thousands of dollars, except for per share amounts)		
Net earnings, as reported .....	\$286,923	\$226,971	\$211,567
Deduct:			
Total stock-based employee compensation expense determined under the fair value based method for all awards, net of related tax .....	(20,940)	(17,740)	(18,790)
Add:			
Stock-based employee compensation expense, net of related tax, included in net earnings, as reported .....	7,256	3,479	4,083
Net earnings, pro forma .....	<u>\$273,239</u>	<u>\$212,710</u>	<u>\$196,860</u>
Earnings per share:			
Basic – as reported .....	\$ 3.18	\$ 2.50	\$ 2.30
Basic – pro forma .....	\$ 3.03	\$ 2.34	\$ 2.14
Diluted – as reported .....	\$ 3.13	\$ 2.46	\$ 2.24
Diluted – pro forma .....	\$ 2.97	\$ 2.31	\$ 2.10

#### ADVERTISING

Advertising costs are expensed in the year the related advertisement is first presented. Advertising expense was \$98.2 million, \$94.9 million and \$87.4 million for 2004, 2003 and 2002, 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 presented by year-end are capitalized as Prepaid expenses. Amounts included in Prepaid expenses at December 31, 2004, 2003 and 2002 were \$18.2 million, \$12.9 million and \$13.7 million, respectively.

#### SOFTWARE COSTS

The Company does not sell, lease or market software. The CD-ROM used by the Company's customers is a version of the catalog and is distributed at no charge. Costs associated with the CD-ROM are expensed in the year incurred.

## 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, with no related income tax effects. Through the third quarter of 2004, the foreign currency translation adjustments were partially offset by the after-tax effects of a designated hedge. Also included in Other comprehensive earnings (losses) are unrealized gains (losses) on investments, net of tax.

The following table sets forth the components of Accumulated other comprehensive earnings (losses):

	As of December 31,		
	2004	2003	2002
	(In thousands of dollars)		
Foreign currency translation adjustments .....	\$ 18,052	\$ 2,594	\$(35,006)
Unrealized (losses) on investments, net of tax.....	<u>—</u>	<u>—</u>	<u>(736)</u>
Total accumulated other comprehensive earnings (losses).....	<u>\$ 18,052</u>	<u>\$ 2,594</u>	<u>\$(35,742)</u>

## CASH FLOWS

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.

## 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 receivable and the historical ratio of actual write-offs to the age of the receivable. 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 \$0.2 million, \$0.2 million and \$0.4 million in 2004, 2003 and 2002, 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 adopted SFAS No. 142, "Goodwill and Other Intangible Assets" effective January 1, 2002. 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.

## 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 associated with this warranty program. 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:

	As of December 31,		
	2004	2003	2002
	(In thousands of dollars)		
Beginning balance .....	\$ 2,863	\$ 3,000	\$ 2,368
Returns .....	(10,387)	(8,143)	(8,415)
Provisions .....	10,952	8,006	9,047
Ending balance .....	<u>\$ 3,428</u>	<u>\$ 2,863</u>	<u>\$ 3,000</u>

## NEW ACCOUNTING STANDARDS

In January 2003, the FASB initially issued Interpretation No. 46 (FIN 46), "Consolidation of Variable Interest Entities." FIN 46 was revised in December 2003 when the FASB issued Interpretation No. 46 (revised December 2003) (FIN 46R), "Consolidation of Variable Interest Entities." FIN 46R is an interpretation of Accounting Research Bulletin No. 51, "Consolidated Financial Statements," that replaces FIN 46 and revises the requirements for consolidation by business enterprises of variable interest entities with specific characteristics. The new consolidation requirements related to variable interest entities are required to be adopted no later than the first reporting period that ends after March 15, 2004 (as of March 31, 2004 for the Company). The Company adopted the provisions of FIN 46R as of January 1, 2004, and adoption did not have an effect on its results of operations or financial position.

In November 2004, the FASB issued SFAS No. 151, "Inventory Costs – an amendment of ARB No. 43, Chapter 4." This statement amends the guidance in Accounting Research Bulletin (ARB) No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage) and requires that those items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal." The statement also requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. The provisions of this statement are effective for inventory costs incurred during fiscal years beginning after June 15, 2005 (as of January 1, 2006 for the Company) and are to be applied prospectively. The Company does not expect adoption of SFAS No. 151 to have a material effect on its results of operations or financial position.

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In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123R). This statement requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. Compensation cost is to be measured based on the estimated fair value of the equity-based compensation awards issued as of the grant date. The related compensation expense will be based on the estimated number of awards expected to vest and will be recognized over the requisite service period (often the vesting period) for each grant. The statement requires the use of assumptions and judgments about future events and some of the inputs to the valuation models will require considerable judgment by management. SFAS No. 123R replaces FASB Statement No. 123 (SFAS No. 123), "Accounting for Share-Based Compensation," and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees." The provisions of SFAS No. 123R are required to be applied by public companies as of the first interim or annual reporting period that begins after June 15, 2005 (as of July 1, 2005 for the Company). The Company intends to continue applying APB Opinion No. 25 to equity-based compensation awards until the effective date of SFAS No. 123R. At the effective date of SFAS No. 123R, the Company expects to use the modified prospective application transition method without restatement of prior interim periods in the year of adoption. This will result in the Company recognizing compensation cost based on the requirements of SFAS No. 123R for all equity-based compensation awards issued after July 1, 2005. For all equity-based compensation awards that are unvested as of July 1, 2005, compensation cost will be recognized for the unamortized portion of compensation cost not previously included in the SFAS No. 123 pro forma footnote disclosure. The Company is currently evaluating the impact that adoption of SFAS No. 123R may have on its results of operations or financial position and expects that the adoption may have a material effect on the Company's results of operations depending on the level and form of future equity-based compensation awards issued.

In December 2004, the FASB issued SFAS No. 152, "Accounting for Real Estate Time-Sharing Transactions – an amendment of FASB Statements No. 66 and 67." This statement amends SFAS No. 66, "Accounting for Sales of Real Estate," and SFAS No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," in association with the issuance of AICPA Statement of Position 04-2, "Accounting for Real Estate Time-Sharing Transactions." The provisions of SFAS No. 152 are effective for financial statements for fiscal years beginning after June 15, 2005 (as of January 1, 2006 for the Company). Restatement of previously issued financial statements is not permitted. The Company does not expect the adoption of SFAS No. 152 to have a material effect on its results of operations or financial position.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets – an amendment of APB Opinion No. 29." The amendments made by SFAS No. 153 are based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. Further, the amendments eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges that do not have commercial substance. The provisions of this statement are effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005 (July 1, 2005 for the Company) and are to be applied prospectively. The Company does not expect the adoption of SFAS No. 153 to have a material effect on its results of operations or financial position.

### **NOTE 3—CUMULATIVE EFFECT OF ACCOUNTING CHANGE**

Effective January 1, 2002, the Company adopted SFAS No. 142, "Goodwill and Other Intangible Assets" and the transition provisions of SFAS No. 141, "Business Combinations." As a result of the application of the new impairment methodology introduced by SFAS No. 142, the Company completed its initial process of evaluating goodwill for impairment and recorded a noncash charge to earnings in 2002 of \$32.3 million (\$23.9 million after-tax, or \$0.26 per diluted share) related to the write-down of goodwill of its Canadian subsidiary, Acklands – Grainger Inc. (Acklands). In performing the initial and periodic impairment reviews, the fair value of the reporting units acquired were estimated using a present value method that discounted future cash flows. When available and as appropriate, comparative market multiples were used to corroborate the results of the discounted cash flows. The Company performs its annual evaluation of goodwill and indefinite lived intangible assets for impairment in the fourth quarter of each year and no further write-downs have been required after the initial write-down noted above.

Previous accounting rules incorporated a comparison of book value to undiscounted cash flows, whereas the new rules require a comparison of book value to discounted cash flows, which are lower. There were no material adjustments relating to the classification of the Company's intangible assets or amortization periods as a result of adopting SFAS No. 142.

**NOTE 4—BUSINESS ACQUISITIONS**

On April 14, 2003, Lab Safety Supply, Inc. (Lab Safety) acquired substantially all of the assets and assumed certain liabilities of Gempler's, a direct marketing division of Gempler's, Inc., located in Wisconsin. The results of Gempler's operations have been included in the Company's consolidated financial statements since that date. Gempler's, with annual sales in 2002 of approximately \$32 million, serves agricultural, horticultural, grounds maintenance and contractor markets with tools, safety supplies, clothing and other items.

The aggregate purchase price was \$36.7 million in cash and \$0.7 million in assumed liabilities. Goodwill recognized in this transaction was \$22.8 million and is expected to be fully deductible for tax purposes. Due to the immaterial nature of this transaction, disclosures of amounts assigned to the acquired assets and liabilities and pro forma results of operations are not considered necessary.

**NOTE 5—SPECIAL CHARGES**

In 2001, the Company shutdown the operations of Material Logic, with the exception of FindMRO, and wrote down its investment in other digital activities. In connection with this shutdown, the Company took a pretax charge against operating earnings of \$39.1 million (after-tax \$23.2 million) in 2001. The Company provided a comprehensive separation package, including outplacement services, to 166 employees whose jobs were eliminated. Severance payments began in the second quarter of 2001 and ended in the second quarter of 2004, when the last severance package expired. Other shutdown costs included lease obligations, which were also settled in the second quarter of 2004. The Company reduced the reserve by \$0.2 million, \$0.6 million and \$1.9 million in 2004, 2003 and 2002, respectively, to reflect management's revised estimate of costs.

The following tables show the activity from January 1, 2002 to December 31, 2004 and balances of the Material Logic restructuring reserve (in thousands of dollars):

	Jan. 1, 2002	Deductions	Adjustments	Dec. 31, 2002
Restructuring reserve (Operating expenses):				
Workforce reductions .....	\$ 4,880	\$(2,737)	\$ (499)	\$ 1,644
Asset and equipment write-offs and disposals .....	936	(936)	—	—
Other shutdown costs .....	3,661	(1,371)	(1,440)	850
	<u>\$ 9,477</u>	<u>\$(5,044)</u>	<u>\$(1,939)</u>	<u>\$ 2,494</u>
	Dec. 31, 2002	Deductions	Adjustments	Dec. 31, 2003
Restructuring reserve (Operating expenses):				
Workforce reductions .....	\$ 1,644	\$(1,100)	\$ (122)	\$ 422
Other shutdown costs .....	850	(202)	(442)	206
	<u>\$ 2,494</u>	<u>\$(1,302)</u>	<u>\$( 564)</u>	<u>\$ 628</u>
	Dec. 31, 2003	Deductions	Adjustments	Dec. 31, 2004
Restructuring reserve (Operating expenses):				
Workforce reductions .....	\$ 422	\$ (325)	\$ (97)	\$ —
Other shutdown costs .....	206	(77)	(129)	—
	<u>\$ 628</u>	<u>\$( 402)</u>	<u>\$( 226)</u>	<u>\$ —</u>

Deductions in 2002 reflect cash payments of \$4.1 million and noncash charges of \$0.9 million. Deductions in 2003 reflect cash payments of \$1.3 million. Deductions in 2004 reflect cash payments of \$0.4 million. The amounts in the adjustments column are reductions to reflect the Company's revised estimate of costs by expense category.

**NOTE 6—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.

**NOTE 7—ALLOWANCE FOR DOUBTFUL ACCOUNTS**

The following table shows the activity in the allowance for doubtful accounts:

	For the Years Ended December 31,		
	2004	2003	2002
	(In thousands of dollars)		
Balance at beginning of period.....	\$ 24,736	\$ 26,868	\$ 30,552
Provision for uncollectible accounts.....	5,159	9,263	13,328
Write-off of uncollectible accounts, less recoveries.....	(6,662)	(11,713)	(17,054)
Foreign currency exchange impact.....	142	318	42
Balance at end of period.....	<u>\$ 23,375</u>	<u>\$ 24,736</u>	<u>\$ 26,868</u>

**NOTE 8—INVENTORIES**

Inventories primarily consist of merchandise purchased for resale.

Inventories would have been \$238.4 million, \$234.4 million and \$227.3 million higher than reported at December 31, 2004, 2003 and 2002, respectively, if the FIFO method of inventory accounting had been used for all Company inventories. Net earnings would have increased by \$2.4 million, \$4.3 million and \$1.9 million for the years ended December 31, 2004, 2003 and 2002, respectively, using the FIFO method of accounting. Inventories using the FIFO method of accounting approximate replacement cost.

**NOTE 9—INVESTMENTS IN UNCONSOLIDATED ENTITIES**

On February 1, 2002, the Company finalized an agreement creating the joint venture USI-AGI Prairies Inc. The joint venture is between Acklands and Uni-Select Inc. (Uni-Select), a Canadian company. The joint venture combined Uni-Select's Western Division with the automotive aftermarket division of Acklands, which operated as Bumper to Bumper. Acklands' contribution of net assets was approximately U.S.\$14.6 million. Additionally, Acklands' carrying value of its investment in this joint venture includes U.S.\$5.1 million of allocated goodwill. The Company has a 50% stake in the new entity, which Uni-Select manages.

No gain or loss was recognized when this transaction was finalized. Through February 1, 2002, the results of the Company's automotive aftermarket parts division were consolidated with Acklands. Since February 2, 2002, the Company has accounted for its joint venture investment using the equity method. In 2003, Acklands made a loan denominated in Canadian dollars to USI-AGI Prairies Inc. of U.S.\$3.7 million bearing interest at market rates. The loan is due and payable on demand.

The Company also has held investments in three Asian joint ventures. In the fourth quarter of 2003, the Company wrote-off its investment in two of these Asian joint ventures due to the uncertainty regarding the future profitability of these joint ventures and their ability to secure sufficient capital funding. In the first quarter of 2004, the Company sold its 11% interest in one of these investments for a gain of \$0.8 million. At December 31, 2004, the ownership percentages of the two remaining investments were 39% and 49%. The Company accounts for these joint ventures using the equity method of accounting.

The table below summarizes the activity of these investments:

	Investment		Cumulative	Divestiture/ Write-off	Foreign	Total
	Cost	Loan	Equity Income (Losses)		Currency Translation Adjustment	
	(In thousands of dollars)					
Balance at January 1, 2002.....	\$ 40,457	\$ —	\$ (18,060)	\$ (17,621)	\$ —	\$ 4,776
USI-AGI Prairies Inc.....	20,580	—	970	—	(595)	20,955
Cash distribution from						
USI-AGI Prairies Inc.....	(8,959)	—	—	—	—	(8,959)
Other equity investments.....	3,211	—	(3,995)	—	—	(784)
Balance at December 31, 2002....	55,289	—	(21,085)	(17,621)	(595)	15,988
USI-AGI Prairies Inc.....	—	3,706	1,442	—	2,802	7,950
Other equity investments.....	4,535	—	(3,730)	(1,921)	—	(1,116)
Balance at December 31, 2003....	59,824	3,706	(23,373)	(19,542)	2,207	22,822
USI-AGI Prairies Inc.....	—	—	2,103	—	1,784	3,887
Other equity investment.....	—	—	(1,107)	—	524	(583)
Balance at December 31, 2004....	<u>\$ 59,824</u>	<u>\$ 3,706</u>	<u>\$ (22,377)</u>	<u>\$ (19,542)</u>	<u>\$ 4,515</u>	<u>\$ 26,126</u>

**NOTE 10—INVESTMENTS**

Investments consist of marketable securities and nonpublicly traded equity securities for which a market value is not readily determinable. Marketable securities are all classified as available for sale and are reported at fair value, with unrealized gains or losses on such securities reflected, net of taxes, in the Accumulated other comprehensive earnings (losses) component of shareholders' equity. In accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," the Company evaluates whether a decline in fair value below cost is other than temporary based on the amount of unrealized losses and their duration. Other-than-temporary impairments are recognized in earnings. Nonpublicly traded equity securities are reported at the lower of cost or estimated net realizable value. Adjustments to net realizable value are recognized in earnings. There have been no dividends earned on these investments. The Company completed the sale of its investments in nonpublicly traded equity securities in 2004 and marketable securities in 2003. The gains on these sales were calculated using the specific identification method and were reported in Unclassified – net.

The original cost, pretax realized gains and unrealized (losses), reductions to net realizable value and fair value of investments are as follows:

	As of December 31,		
	2004	2003	2002
	(In thousands of dollars)		
Marketable securities			
Cost .....	\$ —	\$ —	\$ 6,521
Unrealized losses – net .....	—	—	(1,206)
Fair value .....	—	—	5,315
Nonpublicly traded equity securities, at estimated net realizable value .....	—	—	—
Investments .....	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 5,315</u>
	For the Years Ended December 31,		
	2004	2003	2002
	(In thousands of dollars)		
Proceeds from sales .....	<u>\$ 50</u>	<u>\$ 6,115</u>	<u>\$ 15,957</u>
Realized gains on sales .....	<u>\$ 50</u>	<u>\$ 1,208</u>	<u>\$ 7,308</u>
Reductions to net realizable value .....	<u>\$ —</u>	<u>\$ —</u>	<u>\$ (1,845)</u>

**NOTE 11—CAPITALIZED SOFTWARE**

Amortization of capitalized software is predominately on a straight-line basis over three and five years. Amortization begins when the software is available for its intended use. Amortization expense was \$10.7 million, \$14.0 million and \$17.6 million for the years ended December 31, 2004, 2003 and 2002, 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 and 2003, the Company determined certain capitalized amounts were no longer recoverable and wrote-down the carrying value by \$1.0 million in each year.

**NOTE 12—SHORT-TERM DEBT**

The following summarizes information concerning short-term debt:

	As of December 31,		
	2004	2003	2002
	(In thousands of dollars)		
<u>Bank Debt</u>			
Outstanding at December 31 .....	\$ —	\$ —	\$ 2,967
Maximum month-end balance during the year .....	\$ —	\$ 2,967	\$ 4,194
Average amount outstanding during the year .....	\$ —	\$ 1,382	\$ 3,611
Weighted average interest rate during the year .....	—%	2.6%	3.4%
Weighted average interest rate at December 31 .....	—%	—%	2.9%

The Company and its subsidiaries had committed lines of credit totalling \$250.0 million, \$265.4 million and \$267.7 million at December 31, 2004, 2003 and 2002, respectively. At December 31, 2004 and 2003, there were no borrowings under the committed lines of credit. At December 31, 2002, borrowings under Company committed lines of credit were \$3.0 million. The committed lines of credit at December 31, 2003 and 2002 included \$15.4 million and \$12.7 million, respectively, denominated in Canadian dollars.

The Company also had \$8.3 million, \$7.7 million and \$15.9 million of uncommitted lines of credit denominated in Canadian dollars at December 31, 2004, 2003 and 2002, respectively.

The Company had \$16.0 million, \$15.0 million and \$12.0 million of letters of credit at December 31, 2004, 2003 and 2002, respectively, primarily related to the Company's casualty insurance program. The Company also had \$0.9 million, \$2.5 million and \$0.3 million at December 31, 2004, 2003 and 2002, respectively, in letters of credit to facilitate the purchase of product from foreign sources.

### NOTE 13—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 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 \$74.2 million, \$45.9 million and \$50.0 million for the years ended December 31, 2004, 2003 and 2002, respectively.

*Postretirement Benefits.* The Company has a postretirement healthcare benefits plan that provides coverage for a majority of its retired employees and their dependents should they elect to maintain such coverage. 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 "Medicare Prescription Drug, Improvement and Modernization Act of 2003" (the Medicare Act) was signed into law on December 8, 2003. 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. The Company adopted FASB Staff Position No. 106-2 (FSP 106-2), "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003" in the third quarter ended September 30, 2004. FSP 106-2 provides guidance on the accounting for the effects of the Medicare Act for employers that sponsor postretirement drug healthcare plans that provide prescription drug benefits and requires those employers to provide certain disclosures regarding the effect of the subsidy provided by the Medicare Act. The prospective application method of FSP 106-2 was adopted by the Company and requires the remeasurement of the accumulated projected benefit obligation (APBO) as of the beginning of the period of adoption.

The Company compared its retiree prescription drug coverage to the benefit provided under the Medicare Act and concluded that the benefit provided under its plan is at least actuarially equivalent to the benefit provided under the Medicare Act. The Company's APBO and its net periodic postretirement benefit cost were remeasured as of July 1, 2004, based on the plan provisions in place on the measurement date of January 1, 2004. The remeasurement reflects the effect of the federal subsidy, which begins January 1, 2006. The remeasurement for the subsidy reduced the APBO related to benefits attributed to past service by \$20.8 million. The effect of the subsidy reduced the net periodic postretirement benefit cost for 2004 by \$3.8 million, lowering service costs and interest costs on the APBO by \$1.3 million each, and the amortization of actuarial losses by \$1.2 million.

The net periodic benefit costs charged to operating expenses, which are valued with a measurement date of January 1 for each year, including the effect of the 2004 remeasurement for the Medicare Act, consisted of the following components:

	For the Years Ended December 31,		
	2004	2003	2002
	(In thousands of dollars)		
Service cost.....	\$ 6,380	\$ 6,462	\$ 5,332
Interest cost.....	5,292	5,662	5,097
Expected return on assets .....	(2,064)	(1,081)	(1,192)
Amortization of transition asset .....	(143)	(143)	(143)
Amortization of unrecognized losses .....	1,371	2,002	1,079
Amortization of prior service cost.....	(858)	(641)	(75)
Net periodic benefit costs .....	<u>\$ 9,978</u>	<u>\$ 12,261</u>	<u>\$ 10,098</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 17.5 years.

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:

	2004	2003	2002
	(In thousands of dollars)		
Benefit obligation at the beginning of the year .....	\$107,710	\$ 90,141	\$ 62,811
Service cost.....	6,380	6,462	5,332
Interest cost.....	5,292	5,662	5,097
Plan participant contributions.....	1,364	1,070	929
Amendments .....	(2,843)	(6,903)	—
Actuarial (gain) loss.....	(11,194)	14,172	18,956
Benefits paid .....	(3,328)	(2,894)	(2,984)
Benefit obligation at the end of the year .....	<u>103,381</u>	<u>107,710</u>	<u>90,141</u>
Fair value of plan assets at the beginning of the year .....	34,405	20,013	19,866
Actual return (loss) on plan assets.....	3,026	5,235	(3,738)
Employer contributions.....	6,239	10,981	5,940
Plan participant contributions.....	1,364	1,070	929
Benefits paid .....	(3,328)	(2,894)	(2,984)
Fair value of plan assets at the end of the year .....	<u>41,706</u>	<u>34,405</u>	<u>20,013</u>
Funded status.....	(61,675)	(73,305)	(70,128)
Unrecognized transition asset.....	(1,428)	(1,571)	(1,714)
Unrecognized net actuarial loss.....	26,157	39,685	31,669
Unrecognized prior service cost .....	(8,872)	(6,887)	(625)
Accrued postretirement benefits cost .....	<u>\$ (45,818)</u>	<u>\$ (42,078)</u>	<u>\$ (40,798)</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, 2004 changed the retiree co-payments, coinsurance amounts and out-of-pocket maximums for participants. The plan amendment effective January 1, 2003 changed the prescription drug benefits.

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

	2004	2003	2002
Discount rate .....	5.75%	6.0%	6.5%
Expected long-term rate of return on plan assets, net of tax at 40%..	6.0%	6.0%	5.4%
Initial healthcare cost trend rate .....	10.0%	10.5%	10.0%
Ultimate healthcare cost trend rate .....	5.0%	5.0%	5.0%
Year ultimate healthcare cost trend rate reached .....	2017	2016	2014

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

	2004	2003	2002
Discount rate .....	6.0%	6.5%	7.0%
Expected long-term rate of return on plan assets, net of tax at 40%..	6.0%	5.4%	6.0%
Initial healthcare cost trend rate .....	10.0%	10.5%	10.5%
Ultimate healthcare cost trend rate .....	5.0%	5.0%	5.0%
Year ultimate healthcare cost trend rate reached .....	2017	2016	2014

The discount rate assumptions reflect the rates available on high-quality fixed income debt instruments on December 31 of each year.

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 one-percentage-point change in assumed healthcare cost trend rates would have the following effects on December 31, 2004 results:

	1-Percentage-Point Increase	1-Percentage-Point (Decrease)
	(In thousands of dollars)	
Effect on total of service and interest cost .....	\$ 2,735	\$ (2,114)
Effect on accumulated postretirement benefit obligation at December 31 .....	14,593	(19,582)

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 change in expected long-term rate of return on plan assets did not have a material effect on the net periodic benefit cost for either of the years ended December 31, 2004 or December 31, 2003.

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 \$6.2 million, \$11.0 million and \$5.9 million for the years ended December 31, 2004, 2003 and 2002, respectively. During those years, \$1.7 million, \$2.0 million and \$1.9 million 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: \$2.1 million in 2005, \$2.2 million in 2006, \$2.5 million in 2007, \$2.9 million in 2008, \$3.4 million in 2009 and \$26.6 million over the five-year period covering 2010 through 2014.

#### **NOTE 14—LONG-TERM DEBT**

Long-term debt consisted of the following:

	As of December 31,		
	2004	2003	2002
	(In thousands of dollars)		
Commercial paper .....	\$ —	\$114,127	\$113,807
Derivative instrument .....	—	25,418	991
Industrial development revenue and private activity bonds .....	9,485	9,485	11,400
	<u>9,485</u>	<u>149,030</u>	<u>126,198</u>
Less current maturities .....	9,485	144,135	6,505
	<u>\$ —</u>	<u>\$ 4,895</u>	<u>\$119,693</u>

During the third quarter of 2002, the Company refinanced a C\$180.4 million bank loan that had been designated as a nonderivative hedge of the net investment in the Company's Canadian subsidiary. The bank loan was replaced with 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 U.S.\$140.8 million. The cross-currency swap was based on notional principal amounts of C\$180.4 million and U.S.\$113.7 million, respectively. Initially, the Company gave the counterparty U.S.\$113.7 million and received from the counterparty C\$180.4 million. The Company received interest based on the 30-day U.S. commercial paper rate. At the maturity date of the cross-currency swap, this rate was 1.62%. The Company paid interest to the counterparty based on the 30-day Canadian Bankers' Acceptances rate plus 14 to 19 basis points. At the maturity date of the cross-currency swap, this rate was 2.32%. The outstanding underlying commercial paper was U.S.\$114.2 million with an interest rate of 1.58% at the maturity date of the cross-currency swap. The fair value of the derivative instrument was a liability of U.S.\$28.1 million at the maturity date.

The cross-currency swap was an over-the-counter instrument with a liquid market. The Company established strict counterparty credit guidelines and entered into the transaction with an investment grade financial institution. The Company does not enter into derivative financial instruments for trading purposes.

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 included a U.S.\$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, 2003 and 2002 earnings 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, 2004, the weighted average interest rate was 2.31%. Interest rates on some of the issues are subject to change at certain dates in the future. The bondholders have the right to 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, 2004, 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, 2004. The Company classified \$9.5 million, \$4.6 million and \$6.5 million of bonds currently subject to redemption options in current maturities of long-term debt at December 31, 2004, 2003 and 2002, 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, 2004.

#### **NOTE 15—LEASES**

The Company leases certain land, buildings and equipment. The Company capitalizes all significant leases that qualify for capitalization, of which there were none at December 31, 2004.

At December 31, 2004, the approximate future minimum lease payments for all operating leases were as follows (in thousands of dollars):

	<u>Future Minimum Lease Payments</u>
2005.....	\$22,728
2006.....	16,928
2007.....	14,262
2008.....	10,985
2009.....	8,502
Thereafter.....	<u>12,465</u>
Total minimum payments required.....	\$85,870
Less amounts representing sublease income.....	<u>(271)</u>
	<u>\$85,599</u>

Total rent expense, including both items under lease and items rented on a month-to-month basis, was \$22.3 million, \$19.5 million and \$18.8 million for 2004, 2003 and 2002, respectively. These amounts are net of sublease income of \$0.5 million, \$0.5 million and \$0.4 million for 2004, 2003 and 2002, respectively.

#### **NOTE 16—STOCK INCENTIVE PLANS**

The Company maintains stock incentive plans under which the Company may grant a variety of incentive awards to employees. 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.

The plans authorize 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.

Shares relating to terminated, surrendered or canceled options and stock appreciation rights, to forfeited restricted stock or other awards, or to transactions that result in fewer shares being issued under the plans, are again available for awards under the plans.

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In 2004, 2003 and 2002, the Company provided broad-based stock option grants covering 181,200, 161,300 and 89,600 shares, respectively, to those employees who reached major service milestones and were not participants in other stock option programs.

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.

There were 10,000 shares of restricted stock issued in 2004 with a weighted average fair market value of \$50.66 per share. There were 20,000 shares of restricted stock issued in 2003 with a weighted average fair market value of \$47.72 per share. There were 110,000 shares of restricted stock issued in 2002 with a weighted average fair market value of \$56.31 per share. The shares granted in 2004, 2003, and 2002 vest over periods from three to seven years from issuance, although accelerated vesting is provided in certain instances. Restricted stock vested was 150,000, 96,790 and 112,000 shares in 2004, 2003 and 2002, respectively. Compensation expense related to restricted stock awards is based upon closing market prices on the last trading day preceding the date of grant and is charged to earnings on a straight-line basis over the vesting period. Total compensation expense related to restricted stock was \$4.3 million, \$4.8 million and \$6.4 million in 2004, 2003 and 2002, respectively. There were 5,000, 39,250 and 16,360 shares of restricted stock canceled in 2004, 2003 and 2002, respectively. There were 322,000, 682,000 and 798,040 shares of restricted stock outstanding at December 31, 2004, 2003 and 2002, respectively, and 912,120 shares outstanding at January 1, 2002.

In 2004, the Company began issuing restricted stock units (RSUs) as part of its long-term incentive program for management. Awards of RSUs are provided for and are issued under the W.W. Grainger, Inc. 1990 Long-Term Stock Incentive Plan, as amended. There were 227,300 RSUs granted in 2004 with an average fair market value of \$53.43 per share. RSUs granted in 2004 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.

In 2004, 215,000 shares of previously granted, but unvested, restricted stock were converted into an equivalent number of RSUs. In 2002, 95,720 shares of previously granted, but unvested restricted stock were converted into an equivalent number of RSUs. The RSUs are subject to the same vesting provisions and have the identical financial statement impact as the original restricted stock.

In 2004 and 2003, there were 48,900 and 95,720 RSUs, respectively, that vested. 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. There were 3,505 RSUs settled and 23,600 RSUs canceled in 2004.

Compensation expense related to RSUs 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 vesting period. Total compensation expense related to restricted stock units was \$4.7 million in 2004. At December 31, 2004, there were 510,915 RSUs outstanding. At both December 31, 2003 and 2002, there were 95,720 RSUs outstanding. There were no RSUs outstanding at January 1, 2002.

Nonemployee directors participate in the Company's Director Stock Plan. A total of 327,760 shares of common stock are available for issuance under the plan as of December 31, 2004.

A retainer fee for board service is paid to nonemployee directors in the form of an annual award of unrestricted shares of common stock under the Director Stock Plan. The number of shares awarded is 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, 6,160 and 5,850 in 2004, 2003 and 2002, respectively. The weighted average fair market value of these grants was \$54.54, \$45.50 and \$54.61 for 2004, 2003 and 2002, respectively.

In addition, nonemployee directors receive an annual grant under the Director Stock Plan, denominated in dollars, of options to purchase shares of common stock. The number of shares covered by each option is 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 options are issued at the closing market price on the last trading day preceding the date of grant. The options are fully exercisable upon award and have a ten-year term. Total option awards were 13,360, 15,840 and 14,850 shares in 2004, 2003 and 2002, respectively. No options were canceled or expired in 2004, 2003 or 2002. There were 115,320, 112,470 and 96,630 options outstanding at December 31, 2004, 2003 and 2002, respectively, and 81,780 options outstanding at January 1, 2002.

The Company awards stock units under the Director Stock Plan in connection with deferrals of director fees and dividend equivalents on existing stock units. A stock unit is the economic equivalent of a share of common stock. 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, 2004, 2003 and 2002, there were ten, nine and ten nonemployee directors, respectively, that held stock units. The Company recognized expense (income) for the change in value of equivalent stock units of \$0.9 million, \$(1.0) million and \$0.5 million for 2004, 2003 and 2002, respectively. There were 2,087, 1,978 and 1,834 stock units issued as a result of deferrals of director fees and dividend equivalents in 2004, 2003 and 2002, respectively. Total stock units outstanding were 39,398, 39,506 and 45,556 as of December 31, 2004, 2003 and 2002, respectively.

Transactions involving stock options are summarized as follows:

	Shares Subject to Option	Weighted Average Price Per Share	Options Exercisable
Outstanding at January 1, 2002 .....	8,389,587	\$40.96	<u>2,826,979</u>
Granted .....	2,080,005	\$54.50	
Exercised .....	(706,102)	\$33.68	
Canceled or expired .....	<u>(298,652)</u>	\$42.19	
Outstanding at December 31, 2002 .....	9,464,838	\$44.44	<u>3,320,888</u>
Granted .....	1,856,590	\$45.69	
Exercised .....	(427,857)	\$36.72	
Canceled or expired .....	<u>(479,639)</u>	\$45.90	
Outstanding at December 31, 2003 .....	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 .....	<u>9,205,794</u>	\$46.86	<u>4,415,343</u>

All options were issued at the closing market price on the last trading day preceding the date of grant. Options were issued in 2004, 2003 and 2002 with initial vesting periods ranging from immediate to three years.

Information about stock options outstanding and exercisable as of December 31, 2004, is as follows:

Options Outstanding			
Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life	Exercise Price
\$30.74 – \$37.51	1,826,108	5.2 years	\$36.98
\$37.52 – \$47.26	3,184,785	7.0 years	\$44.66
\$47.27 – \$61.01	<u>4,194,901</u>	6.9 years	\$52.83
	9,205,794	6.6 years	\$46.86
Options Exercisable			
Range of Exercise Prices	Number Exercisable	Weighted Average Exercise Price	
\$30.74 – \$37.51	1,519,628	\$36.88	
\$37.52 – \$47.26	1,582,505	\$43.66	
\$47.27 – \$61.01	<u>1,313,210</u>	\$50.24	
	4,415,343	\$43.28	

Shares available for issuance in connection with awards of stock options, stock appreciation rights, stock units, shares of common stock, restricted shares of common stock and other stock-based awards to employees and directors were 1,201,876, 2,016,160 and 2,161,563 at December 31, 2004, 2003 and 2002, respectively.

The weighted average fair value of the stock options granted during 2004, 2003 and 2002 was \$13.08, \$10.43 and \$14.77, respectively. The fair value of each option grant was estimated using the Black-Scholes option-pricing model based on the date of the grant and the following weighted average assumptions:

	<u>2004</u>	<u>2003</u>	<u>2002</u>
Risk-free interest rate.....	4.1%	3.4%	4.9%
Expected life.....	7 years	7 years	7 years
Expected volatility.....	20.1%	20.1%	20.1%
Expected dividend yield.....	1.8%	1.8%	1.8%

See Note 2 to the Consolidated Financial Statements for the pro forma net earnings and earnings per share, as calculated under SFAS No. 123.

#### **NOTE 17—CAPITAL STOCK**

The Company had no shares of preferred stock outstanding as of December 31, 2004, 2003 and 2002. The activity of outstanding common stock and common stock held in treasury was as follows:

	<u>2004</u>		<u>2003</u>		<u>2002</u>	
	Outstanding Common Stock	Treasury Stock	Outstanding Common Stock	Treasury Stock	Outstanding Common Stock	Treasury Stock
Balance at beginning of period .....	91,020,989	18,356,227	91,568,055	17,449,587	93,344,641	15,129,062
Exercise of stock options .....	1,825,085	(1,319,363)	415,244	(5,500)	582,243	(1,000)
Issuance and vesting of restricted stock, net of 45,647, 30,920 and 35,224 shares retained, respectively.....	(35,647)	45,647	(10,920)	—	74,776	—
Settlement of restricted stock units, net of 1,015 shares retained .....	2,490	(2,490)	—	—	—	—
Cancellation of restricted shares ..	(5,000)	—	(39,250)	—	(16,360)	—
Conversion of restricted stock to restricted stock units.....	(215,000)	—	—	—	(95,720)	—
Purchase of 4,801,600 shares of stock, net of 4,695,725 treasury shares transferred in connection with related party transaction .....	—	—	—	—	(105,875)	105,875
Purchase of treasury shares, net of 5,510, 6,160 and 5,850 shares issued, respectively .....	(1,995,490)	1,995,490	(912,140)	912,140	(2,215,650)	2,215,650
Balance at end of period .....	<u>90,597,427</u>	<u>19,075,511</u>	<u>91,020,989</u>	<u>18,356,227</u>	<u>91,568,055</u>	<u>17,449,587</u>

#### **NOTE 18—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:

	For the Years Ended December 31,		
	2004	2003	2002
	(In thousands of dollars)		
Current provision:			
Federal .....	\$135,391	\$121,671	\$140,453
State .....	24,815	22,307	24,696
Foreign .....	2,460	4,759	3,680
Total current.....	162,666	148,737	168,829
Deferred tax (benefit) provision:			
Federal .....	(5,986)	3,454	(7,295)
State .....	(684)	395	(834)
Foreign .....	2,220	1,533	1,649
Total deferred .....	(4,450)	5,382	(6,480)
Total provision.....	<u>\$158,216</u>	<u>\$154,119</u>	<u>\$162,349</u>

The income tax effects of temporary differences that gave rise to the net deferred tax asset were:

	As of December 31,		
	2004	2003	2002
	(In thousands of dollars)		
Deferred tax assets:			
Inventory .....	\$ 37,927	\$ 42,365	\$ 38,583
Accrued expenses .....	31,219	28,841	30,418
Accrued employment-related benefits .....	65,760	56,449	54,063
Intangibles .....	663	4,896	8,700
Foreign operating loss carryforwards .....	9,616	10,248	10,032
Unrealized capital losses .....	649	4,671	1,950
Tax benefit related to designated hedge .....	—	9,914	387
Other.....	4,129	1,401	2,830
Deferred tax assets .....	149,963	158,785	146,963
Less valuation allowance .....	(10,265)	(14,919)	(11,982)
Deferred tax assets, net of valuation allowance.....	<u>\$139,698</u>	<u>\$143,866</u>	<u>\$134,981</u>
Deferred tax liabilities:			
Purchased tax benefits.....	\$ (10,090)	\$ (11,008)	\$ (11,854)
Property, buildings and equipment .....	(9,594)	(9,154)	(5,273)
Other.....	(8,696)	(3,909)	(1,977)
Deferred tax liabilities.....	(28,380)	(24,071)	(19,104)
Net deferred tax asset .....	<u>\$111,318</u>	<u>\$119,795</u>	<u>\$115,877</u>
The net deferred tax asset is classified as follows:			
Current assets .....	\$ 96,929	\$ 99,499	\$ 95,336
Noncurrent assets .....	18,871	20,296	20,541
Noncurrent liabilities (foreign) .....	(4,482)	—	—
Net deferred tax asset .....	<u>\$111,318</u>	<u>\$119,795</u>	<u>\$115,877</u>

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

At December 31, 2004, the Company had \$35.8 million of foreign operating loss carryforwards related to a foreign operation, which begin to expire in 2006. 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 changes in the valuation allowance were as follows:

	For the Years Ended December 31,		
	2004	2003	2002
	(In thousands of dollars)		
Beginning balance .....	\$ 14,919	\$ 11,982	\$ 13,934
(Decrease) increase related to foreign net operating loss carryforwards.....	(632)	216	(586)
(Realized) unrealized capital losses .....	(4,022)	2,721	(1,366)
Ending balance .....	<u>\$ 10,265</u>	<u>\$ 14,919</u>	<u>\$ 11,982</u>

A reconciliation of income tax expense with federal income taxes at the statutory rate follows:

	For the Years Ended December 31,		
	2004	2003	2002
	(In thousands of dollars)		
Federal income tax at the statutory rate.....	\$155,799	\$133,382	\$139,243
State income taxes, net of federal income tax benefit .....	16,130	14,500	15,404
Foreign operations tax effects .....	(661)	1,025	1,631
Tax benefit of capital loss carrybacks .....	(3,778)	—	—
Tax benefit of tax-free Medicare subsidy .....	(1,865)	—	—
Other – net .....	(7,409)	5,212	6,071
Income tax expense .....	<u>\$158,216</u>	<u>\$154,119</u>	<u>\$162,349</u>
Effective tax rate .....	<u>35.5%</u>	<u>40.4%</u>	<u>40.8%</u>

The Company has not provided for U.S. federal income taxes or tax benefits on the undistributed earnings or losses of its foreign subsidiaries. In the opinion of management, such earnings will continue to be indefinitely reinvested. At December 31, 2004, there were no undistributed earnings of foreign subsidiaries that would be subject to U.S. income taxes, if such earnings were repatriated.

The Company is continuously undergoing examination of its federal income tax returns by the Internal Revenue Service (the IRS). The Company and the IRS have settled tax years through 2001. The IRS is currently examining the Company's 2002 and 2003 federal income tax returns. 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.

#### **NOTE 19—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 2.7 million, 3.5 million and 2.7 million for the years ended December 31, 2004, 2003 and 2002, 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,		
	2004	2003	2002
	(In thousands of dollars, except for per share amounts)		
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>
Denominator for basic earnings per share —			
weighted average shares .....	90,207	90,731	91,982
Effect of dilutive securities – stock-based compensation .....	<u>1,466</u>	<u>1,663</u>	<u>2,321</u>
Denominator for diluted earnings per share —			
weighted average shares adjusted for dilutive securities .....	<u>91,673</u>	<u>92,394</u>	<u>94,303</u>
Basic earnings per share before cumulative			
effect of accounting change .....	\$ 3.18	\$ 2.50	\$ 2.56
Cumulative effect of accounting change .....	<u>—</u>	<u>—</u>	<u>(0.26)</u>
Basic earnings per common share .....	<u>\$ 3.18</u>	<u>\$ 2.50</u>	<u>\$ 2.30</u>
Dilutive earnings per share before cumulative			
effect of accounting change .....	\$ 3.13	\$ 2.46	\$ 2.50
Cumulative effect of accounting change .....	<u>—</u>	<u>—</u>	<u>(0.26)</u>
Dilutive earnings per common share .....	<u>\$ 3.13</u>	<u>\$ 2.46</u>	<u>\$ 2.24</u>

#### **NOTE 20—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 21—SEGMENT INFORMATION**

The Company reports three segments: Branch-based Distribution, Lab Safety and Integrated Supply. The Branch-based Distribution segment provides customers with solutions to their immediate facilities maintenance and other needs. Branch-based Distribution is an aggregation of the following: Industrial Supply, Acklands (Canada), FindMRO, Export, Global Sourcing, Parts, Grainger, S.A. de C.V. (Mexico), Grainger Caribe Inc. (Puerto Rico) and China Distribution. Lab Safety is a direct marketer of safety and other industrial products. Integrated Supply serves customers who have chosen to outsource a portion or all of their indirect materials management processes.

The Company's segments offer differing ranges of services and products and require 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.

	2004			
	Branch-based Distribution	Lab Safety	Integrated Supply	Total
	(In thousands of dollars)			
Total net sales.....	\$4,519,951	\$336,720	\$211,065	\$5,067,736
Intersegment net sales.....	(15,873)	(2,078)	—	(17,951)
Net sales to external customers.....	\$4,504,078	\$334,642	\$211,065	\$5,049,785
Segment operating earnings .....	\$ 461,367	\$ 45,467	\$ 2,461	\$ 509,295
Segment assets.....	\$2,006,128	\$144,471	\$ 28,496	\$2,179,095
Depreciation and amortization .....	74,403	7,870	1,205	83,478
Additions to long-lived assets.....	155,087	2,910	79	158,076

	2003			
	Branch-based Distribution	Lab Safety	Integrated Supply	Total
	(In thousands of dollars)			
Total net sales.....	\$4,167,164	\$305,480	\$211,679	\$4,684,323
Intersegment net sales.....	(15,496)	(1,813)	—	(17,309)
Net sales to external customers.....	\$4,151,668	\$303,667	\$211,679	\$4,667,014
Segment operating earnings .....	\$ 390,183	\$ 41,885	\$ 3,201	\$ 435,269
Segment assets.....	\$1,851,640	\$142,466	\$ 40,094	\$2,034,200
Depreciation and amortization .....	65,744	7,239	1,286	74,269
Additions to long-lived assets.....	73,287	33,123	1,839	108,249

	2002			
	Branch-based Distribution	Lab Safety	Integrated Supply	Total
	(In thousands of dollars)			
Total net sales.....	\$4,147,955	\$286,797	\$225,967	\$4,660,719
Intersegment net sales.....	(15,411)	(1,410)	—	(16,821)
Net sales to external customers.....	\$4,132,544	\$285,387	\$225,967	\$4,643,898
Segment operating earnings .....	\$ 394,861	\$ 47,105	\$ 6,231	\$ 448,197
Segment assets.....	\$1,872,471	\$104,372	\$ 29,539	\$2,006,382
Depreciation and amortization .....	68,966	6,421	1,214	76,601
Additions to long-lived assets.....	123,039	2,127	1,581	126,747

Following are reconciliations of the segment information with the consolidated totals per the financial statements:

	2004	2003	2002
		(In thousands of dollars)	
Operating earnings:			
Total operating earnings for reportable segments .....	\$ 509,295	\$ 435,269	\$ 448,197
Unallocated expenses.....	(69,765)	(48,008)	(55,042)
Total consolidated operating earnings.....	<u>\$ 439,530</u>	<u>\$ 387,261</u>	<u>\$ 393,155</u>
Assets:			
Total assets for reportable segments .....	\$2,179,095	\$2,034,200	\$2,006,382
Unallocated assets.....	<u>630,478</u>	<u>590,478</u>	<u>431,066</u>
Total consolidated assets.....	<u>\$2,809,573</u>	<u>\$2,624,678</u>	<u>\$2,437,448</u>

	2004		
	Segment Totals	Unallocated	Consolidated Total
Other significant items:	(In thousands of dollars)		
Depreciation and amortization .....	\$ 83,478	\$ 14,778	\$ 98,256
Additions to long-lived assets .....	\$ 158,076	\$ 2,682	\$ 160,758
Geographic Information:		Revenues	Long-lived Assets
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>
		2003	
	Segment Totals	Unallocated	Consolidated Total
Other significant items:	(In thousands of dollars)		
Depreciation and amortization .....	\$ 74,269	\$ 15,984	\$ 90,253
Additions to long-lived assets .....	\$ 108,249	\$ 3,680	\$ 111,929
Geographic Information:		Revenues	Long-lived Assets
United States .....		\$4,183,321	\$ 773,411
Canada .....		393,938	143,007
Other foreign countries .....		89,755	4,052
		<u>\$4,667,014</u>	<u>\$ 920,470</u>
		2002	
	Segment Totals	Unallocated	Consolidated Total
Other significant items:	(In thousands of dollars)		
Depreciation and amortization .....	\$ 76,601	\$ 16,887	\$ 93,488
Additions to long-lived assets .....	\$ 126,747	\$ 17,278	\$ 144,025
Geographic Information:		Revenues	Long-lived Assets
United States .....		\$4,215,483	\$ 762,661
Canada .....		342,489	118,979
Other foreign countries .....		85,926	4,109
		<u>\$4,643,898</u>	<u>\$ 885,749</u>

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

Revenues are attributed to countries based on the 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 \$21.8 million in the year ended December 31, 2004 when compared with the prior year. The year-over-year variance included increases in payroll and benefits at headquarters driven by stock-based compensation, and bonus and profit sharing accruals, as well as higher severance and benefits related to organizational changes made during 2004.

The change in the carrying amount of goodwill by segment from December 31, 2002 to December 31, 2004 is as follows:

Goodwill, net by Segment	Branch-	Lab	Integrated	Total
	Distribution	Safety	Supply	
	(In thousands of dollars)			
Balance at December 31, 2002 .....	\$ 89,323	\$25,105	\$ —	\$114,428
Acquisition.....	—	22,823	—	22,823
Translation.....	19,018	—	—	19,018
Balance at December 31, 2003 .....	108,341	47,928	—	156,269
Translation.....	8,742	—	—	8,742
Balance at December 31, 2004 .....	<u>\$117,083</u>	<u>\$47,928</u>	<u>\$ —</u>	<u>\$165,011</u>

**NOTE 22—SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)**

A summary of selected quarterly information for 2004 and 2003 is as follows:

	2004 Quarter Ended				
	(In thousands of dollars, except for per share amounts)				
	March 31	June 30	September 30	December 31	Total
Net sales .....	\$1,227,799	\$1,255,974	\$1,301,057	\$1,264,955	\$5,049,785
Cost of merchandise sold .....	780,334	796,147	821,774	744,878	3,143,133
Gross profit .....	447,465	459,827	479,283	520,077	1,906,652
Warehousing, marketing and administrative expenses .....	346,717	353,162	371,839	395,630	1,467,348
Restructuring charge .....	—	(226)	—	—	(226)
Operating earnings.....	100,748	106,891	107,444	124,447	439,530
Net earnings .....	62,559	66,619	67,689	90,056	286,923
Earnings per share – basic.....	0.69	0.74	0.75	1.00	3.18
Earnings per share – diluted.....	\$ 0.69	\$ 0.72	\$ 0.74	\$ 0.98	\$ 3.13

  

	2003 Quarter Ended				
	(In thousands of dollars, except for per share amounts)				
	March 31	June 30	September 30	December 31	Total
Net sales .....	\$1,139,269	\$1,172,661	\$1,200,669	\$1,154,415	\$4,667,014
Cost of merchandise sold .....	729,160	754,528	775,805	716,020	2,975,513
Gross profit .....	410,109	418,133	424,864	438,395	1,691,501
Warehousing, marketing and administrative expenses .....	318,702	325,353	330,543	330,206	1,304,804
Restructuring charge .....	—	—	—	(564)	(564)
Operating earnings.....	91,407	92,780	94,321	108,753	387,261
Net earnings .....	52,404	55,993	56,836	61,738	226,971
Earnings per share – basic.....	0.58	0.61	0.63	0.68	2.50
Earnings per share – diluted.....	\$ 0.57	\$ 0.60	\$ 0.62	\$ 0.67	\$ 2.46

In the fourth quarter of 2004, the Company reduced its income tax rate for the year to 35.5% from its previous projection of 38.0%. This reduction was primarily due to the recognition of tax benefits from the Medicare Act, capital loss carrybacks created by the sale of investment securities and the resolution of certain federal and state tax contingencies. The reduction in rate was not determinable until the fourth quarter when these items were finalized and their effect on the rate quantified.

**NOTE 23—RELATED PARTY TRANSACTION**

On February 28, 2002, the Company purchased substantially all of the assets, consisting of 4,801,600 shares of Company common stock and cash, of Mountain Capital Corporation, a Nevada corporation (MCC). In exchange, the Company transferred to MCC 4,695,725 shares of Company common stock. The number of shares transferred reflected a 1.5% discount (72,024 shares) from the number of shares received, and additionally reflected other adjustments designed to reimburse the Company for its direct transaction expenses of \$0.6 million (10,549 shares) and for the Company's payment of indebtedness of MCC of \$1.3 million (23,302 shares). The effect on the Company of this transaction was to increase the number of shares held as Treasury stock, thereby reducing the number of shares outstanding by 105,875 shares. The shares received by MCC from the Company were subsequently distributed to the MCC shareholders pursuant to a plan of complete liquidation of MCC.

The transaction documentation includes:

- (i) a Purchase Agreement containing the terms and conditions of the transaction;
- (ii) an Escrow Agreement providing for the pledge by MCC of 10% of the shares received in the transaction, and the pledge by the MCC shareholders of the escrowed shares, as security for the indemnification obligations and liabilities of MCC and the MCC shareholders and
- (iii) a Share Transfer Restriction Agreement providing for certain restrictions on the transfer of Company common stock received by or otherwise held by the MCC shareholders and certain other parties to that agreement.

Prior to the transaction, James D. Slavik, a Company director, was the president and a director of MCC. In addition, Mr. Slavik and certain members of his family owned all of the outstanding stock of MCC either directly or indirectly, including through family trusts of which Mr. Slavik served as trustee. Mr. Slavik was not present and did not participate in any of the deliberations of the Board of Directors or any of its committees relating to the review, consideration or approval of the transaction.

**NOTE 24—UNCLASSIFIED – NET**

The components of Unclassified – net were as follows:

	For the Years Ended December 31,		
	2004	2003	2002
	(In thousands of dollars)		
Gains on sales of investment securities .....	\$ 50	\$ 1,208	\$ 7,308
Gains on sales of fixed assets .....	2,198	3,110	6,409
Other income items .....	334	198	1,106
Total income .....	<u>2,582</u>	<u>4,516</u>	<u>14,823</u>
Write-down of investments .....	—	(1,614)	(3,192)
Losses on sales of fixed assets .....	(473)	(1,503)	(1,190)
Other expense items .....	(234)	(693)	(1,144)
Total expense .....	<u>(707)</u>	<u>(3,810)</u>	<u>(5,526)</u>
Unclassified – net .....	<u>\$ 1,875</u>	<u>\$ 706</u>	<u>\$ 9,297</u>

**NOTE 25—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. 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 28, 2005, the Company is named in cases filed on behalf of approximately 3,700 plaintiffs in which there is an allegation of exposure to asbestos and/or silica. In addition, during 2004, five cases previously filed against the Company alleging exposure to cotton dust were amended to include allegations relating to asbestos; these cases involve approximately 2,100 plaintiffs.

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The Company has denied, or intends to deny, the allegations in all of the above-described lawsuits. In 2004, lawsuits relating to asbestos and/or silica and involving approximately 700 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, it would attempt to exercise indemnification remedies against the product manufacturer. In addition, the Company believes that a substantial portion 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 its consolidated financial position or results of operations.

On September 28, 2004, the U.S. Environmental Protection Agency (EPA) filed an administrative complaint against the Company seeking a civil penalty of \$0.4 million for alleged violations of federal clean-air law and regulations. The complaint alleges that the Company sold a “non-essential” wheel chock product which contained and/or was manufactured with an ozone-depleting substance (ODS). The complaint also alleges that the Company sold aerosol cleaning fluids containing an ODS without displaying proper notification where the products were sold. According to the complaint, the Company sold the cleaning fluids to persons who did not provide proof that they were commercial purchasers and failed to verify that such persons were commercial purchasers. The Company does not believe that the resolution of this matter will have a material adverse effect on its 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. These include 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. 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 its consolidated financial position or results of operations.

#### **NOTE 26—SUBSEQUENT EVENTS**

On January 7, 2005, Lab Safety, a wholly owned subsidiary of the Company, signed a definitive agreement to acquire substantially all of the assets and certain liabilities of AW Direct, Inc. (AW Direct). AW Direct is a direct marketer of products to the service vehicle accessories market. The acquisition subsequently closed on January 14, 2005. The final purchase price is expected to be approximately \$25 million in cash and approximately \$2 million in assumed liabilities. Any goodwill recognized in this transaction will be deductible for tax purposes.

AW Direct, with 2004 sales of more than \$28 million, sells general towing and work truck equipment and accessories to customers in the auto service, utilities, government and construction markets. AW Direct will be operated as a wholly owned subsidiary of Lab Safety.

## COMPUTATIONS OF EARNINGS PER SHARE

	2004	2003	2002
<b>BASIC:</b>			
Weighted average number of shares outstanding during the year.....	<u>90,206,773</u>	<u>90,731,013</u>	<u>91,982,430</u>
Earnings before cumulative effect of accounting change .....	\$286,923,000	\$226,971,000	\$235,488,000
Cumulative effect of accounting change .....	<u>—</u>	<u>—</u>	<u>(23,921,000)</u>
Net earnings .....	<u>\$286,923,000</u>	<u>\$226,971,000</u>	<u>\$211,567,000</u>
Earnings per share before cumulative effect of accounting change .....	\$ 3.18	\$ 2.50	\$ 2.56
Cumulative effect of accounting change per share .....	<u>—</u>	<u>—</u>	<u>(0.26)</u>
Earnings per share .....	<u>\$ 3.18</u>	<u>\$ 2.50</u>	<u>\$ 2.30</u>
<b>DILUTED:</b>			
Weighted average number of shares outstanding during the year.....	90,206,773	90,731,013	91,982,430
Potential shares:			
Shares issuable under common stock equivalents.....	8,445,302	7,571,428	8,012,752
Shares which could have been purchased using the proceeds from the common stock equivalents exercised, based on the average market value for the year .....	<u>(7,015,367)</u>	<u>(5,920,171)</u>	<u>(5,721,423)</u>
	1,429,935	1,651,257	2,291,329
Dilutive effect of exercised options prior to being exercised .....	<u>36,667</u>	<u>11,815</u>	<u>29,738</u>
	<u>1,466,602</u>	<u>1,663,072</u>	<u>2,321,067</u>
Adjusted weighted average number of shares outstanding during the year .....	<u>91,673,375</u>	<u>92,394,085</u>	<u>94,303,497</u>
Earnings before cumulative effect of accounting change .....	\$286,923,000	\$226,971,000	\$235,488,000
Cumulative effect of accounting change .....	<u>—</u>	<u>—</u>	<u>(23,921,000)</u>
Net earnings .....	<u>\$286,923,000</u>	<u>\$226,971,000</u>	<u>\$211,567,000</u>
Earnings per share before cumulative effect of accounting change .....	\$ 3.13	\$ 2.46	\$ 2.50
Cumulative effect of accounting change per share .....	<u>—</u>	<u>—</u>	<u>(0.26)</u>
Earnings per share .....	<u>\$ 3.13</u>	<u>\$ 2.46</u>	<u>\$ 2.24</u>

We hereby consent to the incorporation of our report dated February 11, 2005 accompanying the consolidated financial statements and management's assesment of the effectiveness of internal control over financial reporting on page 25 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 and 333-105185) and on Form S-4 (No. 33-32091) of W.W. Grainger, Inc.

GRANT THORNTON LLP

Chicago, Illinois  
February 25, 2005

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 25, 2005

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 25, 2005

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, 2004, (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 25, 2005

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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, 2004, (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 25, 2005