UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2005

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission File Number 1-5684

W.W. Grainger, Inc.

(Exact name of registrant as specified in its charter)

Illinois (State or other jurisdiction of incorporation or organization)	**36-1150280** (I.R.S. Employer Identification No.)
100 Grainger Parkway, Lake Forest, Illinois (Address of principal executive offices)	**60045-5201** (Zip Code)

(847) 535-1000
(Registrant's telephone number including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	**Name of each exchange on which registered**
Common Stock $0.50 par value, and accompanying Preferred Share Purchase Rights	New York Stock Exchange Chicago Stock Exchange

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes __X__ No _______

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes _______ No __X__

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes __X__ No _______

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy of information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. (X)

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer [X] Accelerated filer [ ] Non-accelerated filer [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes _______ No __X__

The aggregate market value of the voting common equity held by nonaffiliates of the registrant was $4,186,000,325 as of the close of trading as reported on the New York Stock Exchange on June 30, 2005. The Company does not have nonvoting common equity.

The registrant had 89,951,935 shares of common stock outstanding as of January 31, 2006.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the proxy statement relating to the annual meeting of shareholders of the registrant to be held on April 26, 2006, are incorporated by reference into Part III hereof.

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PART I

Item 1: Business

The Company

W.W. Grainger, Inc., incorporated in the State of Illinois in 1928, is in the service business. It distributes products used by businesses and institutions across North America to keep their facilities and equipment running. In this report, the words "Grainger" or "Company" mean W.W. Grainger, Inc. and its subsidiaries.

Grainger uses a multichannel business model to serve approximately 1.7 million customers of all sizes with multiple ways to find and purchase facilities maintenance and other products through a network of branches, field sales representatives, call centers, catalogs and other direct marketing media and the Internet. Orders can be placed via telephone, fax, Internet or in person. Products are available for immediate pick-up or for shipment.

Effective January 1, 2005, Grainger changed its organizational structure. The Integrated Supply division, which had been reported as a separate segment, was merged into Industrial Supply. Operations are now managed and reported in two segments: Branch-based Distribution and Lab Safety. Prior year segment amounts have been restated to maintain comparability. Branch-based Distribution is an aggregation of the following business units: Industrial Supply, Acklands – Grainger Inc. (Canada), 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.

Grainger has internal business support functions which provide coordination and guidance in the areas of accounting, administrative services, business development, communications, compensation and benefits, employee development, enterprise systems, finance, human resources, insurance and risk management, internal audit, investor relations, legal, real estate and construction services, security and safety, taxes and treasury services. These services are provided in varying degrees to all business units.

Grainger does not engage in basic or substantive product research and development activities. Items are regularly added to and deleted from Grainger's product lines on the basis of market research, recommendations of customers and suppliers, sales volumes and other factors.

Branch-based Distribution

The Branch-based Distribution businesses provide North American customers with product solutions for facility maintenance and other product needs through logistics networks, which are configured for rapid product availability. Grainger offers a broad selection of facility maintenance and other products through local branches, catalogs and the Internet. The Branch-based Distribution businesses consist of the following Grainger divisions: Industrial Supply, Acklands – Grainger Inc. (Canada), Grainger, S.A. de C.V. (Mexico), Grainger Caribe Inc. (Puerto Rico) and China Distribution. The more significant of these businesses are described below.

Industrial Supply

Industrial Supply offers U.S. businesses and institutions a combination of product breadth, local availability, speed of delivery, detailed product information, simplicity of ordering and competitively priced products. Industrial Supply distributes material handling equipment, safety and security supplies, lighting and electrical products, tools and test instruments, pumps and plumbing supplies, cleaning and painting supplies and many other items. Its customers range from small and medium-sized businesses to large corporations and governmental and other institutions. During 2005, Industrial Supply completed an average of 91,000 sales transactions daily.

Industrial Supply operates 416 branches located in all 50 states. These branches are generally located within 20 minutes of the majority of U.S. businesses and serve the immediate needs of their local markets by allowing customers to pick up items directly from the branches.

Branches range in size from small, will-call branches to large master branches. The Grainger Express® will-call branches average 2,100 square feet, do not stock inventory and provide convenient pick-up locations. Branches primarily fulfill counter and will-call needs and provide customer service. Master branches handle a higher volume of counter and will-call customers daily, in addition to shipping to customers for themselves and other branches in their area. On average, a branch is 20,000 square feet in size, has 11 employees and handles about 130 transactions per day. In 2005, Industrial Supply opened 16 full-size and five will-call branches, relocated eight branches and expanded or remodeled 14 branches. Ten full-size and three will-call branches were closed in 2005.

Industrial Supply's distribution network is comprised of ten distribution centers (DCs) that handle most of the customer shipping and also replenish branch inventories. The DCs, using automated equipment and processes, ship orders directly to customers for all branches located in their service areas. One DC located in Chicago is also a national distribution center providing customers and the entire network with slower-moving inventory items. A second DC in the Chicago area stocks parts and accessories.

Industrial Supply sells principally to customers in industrial and commercial maintenance departments, service shops, manufacturers, hotels, government, retail organizations, transportation businesses, contractors, and healthcare and educational facilities. Sales transactions during 2005 were made to approximately 1.3 million customers. Approximately 24% of 2005 sales consisted of private label items bearing the Company's registered trademarks, including DAYTON® (principally electric motors, heating and ventilation equipment), TEEL® (liquid pumps), SPEEDAIRE® (air compressors), AIR HANDLER® (air filtration equipment), DEM-KOTE® (spray paints), WESTWARD® (principally hand and power tools), CONDOR™ (safety products) and LUMAPRO® (task and outdoor lighting). Grainger has taken steps to protect these trademarks against infringement and believes that they will remain available for future use in its business. Sales of remaining items generally consisted of products carrying the names of other well-recognized brands.

The Industrial Supply catalog, to be issued in April 2006, offers more than 115,000 facility maintenance and other products. Approximately 1.5 million copies of the catalog were produced.

Customers can also purchase products through grainger.com. This Web site serves as a prominent service channel for the Industrial Supply division. Customers have access to more than 300,000 products through grainger.com. It is available 24/7, providing real-time product availability, customer-specific pricing, multiple product search capabilities, customer personalization, and links to customer support and the fulfillment system. For large customers interested in connecting to grainger.com through sophisticated purchasing platforms, grainger.com has a universal connection. This technology translates the different data formats used by electronic marketplaces, exchanges, and e-procurement systems and allows these systems to communicate directly with Industrial Supply's operating platform.

Industrial Supply purchases products for sale from approximately 1,000 domestic suppliers, most of which are manufacturers. No single supplier comprised more than 10% of Industrial Supply's purchases and no significant difficulty has been encountered with respect to sources of supply.

Through the Global Sourcing operation, Industrial Supply procures competitively priced, high-quality products produced primarily outside the United States from almost 200 suppliers. Grainger businesses sell these items primarily under private labels. Products obtained through Global Sourcing include WESTWARD® tools, LUMAPRO® lighting products and CONDOR™ safety products, as well as products bearing other trademarks.

Acklands – Grainger Inc. (Acklands)

Acklands is Canada's leading broad-line distributor of industrial, automotive fleet and safety supplies. It serves customers through 165 branches and five distribution centers across Canada. Acklands distributes tools, lighting products, safety supplies, pneumatics, instruments, welding equipment and supplies, motors, shop equipment, fan belts and many other items. During 2005, approximately 15,000 sales transactions were completed daily. A comprehensive catalog, printed in both English and French, showcases the product line to facilitate customer selection. This catalog, with more than 40,000 products, supports the efforts of field sales representatives throughout Canada. In addition, customers can purchase products through acklandsgrainger.com.

Mexico

Grainger's operations in Mexico provide local businesses with facility maintenance and other products from both Mexico and the United States. From its six locations in Mexico and U.S. branches along the border, the business provides delivery of approximately 41,000 products throughout Mexico. The largest facility, a 90,000 square foot DC, is located outside of Monterrey, Mexico. During 2005 approximately 900 transactions were completed daily. Customers can order products using a Spanish-language general catalog or purchase them through grainger.com.mx.

Lab Safety

Lab Safety is a direct marketer of safety and other industrial products to U.S. and Canadian businesses. Headquartered in Janesville, Wisconsin, Lab Safety primarily reaches its customers through the distribution of multiple branded catalogs and other marketing materials distributed throughout the year to targeted markets. Brands include LSS, Ben Meadows (forestry), Gempler's (agriculture) and AW Direct (service vehicle accessories). Customers can purchase products through lss.com, benmeadows.com, gemplers.com and awdirect.com.

Lab Safety offers extensive product depth, technical support and high service levels. During 2005, Lab Safety issued ten unique catalogs covering safety supplies, material handling and facility maintenance products, lab supplies, security and other products targeted to specific customer groups. Lab Safety provides access to approximately 130,000 products through its targeted catalogs.

Industry Segments

Effective January 1, 2005, Grainger changed its organizational structure. The Integrated Supply division, which had been reported as a separate segment, was merged into Industrial Supply. Operations are now managed and reported in two segments: Branch-based Distribution and Lab Safety. Prior year segment amounts have been restated to maintain comparability. Branch-based Distribution is an aggregation of the following business units:

Industrial Supply, Acklands – Grainger Inc. (Canada), 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. For segment and geographical information and consolidated net sales and operating earnings see **"Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations"** and **"Item 8: Financial Statements and Supplementary Data."**

Competition

Grainger faces competition in all markets it serves, from manufacturers (including some of its own suppliers) that sell directly to certain segments of the market, wholesale distributors, catalog houses and certain retail enterprises.

Grainger provides local product availability, sales representatives, competitive pricing, catalogs (which include product descriptions and, in certain cases, extensive technical and application data), electronic and Internet commerce technology and other services to assist customers in lowering their total facility maintenance costs. Grainger believes that it can effectively compete with manufacturers on small orders, but manufacturers may have an advantage in filling large orders.

Grainger serves a number of diverse markets. Based on available data, Grainger estimates the North American market for facilities maintenance and related products to be more than $140 billion, of which Grainger's share is approximately 4 percent. There are several large competitors, although most of the market is served by small local and regional competitors.

Employees

As of December 31, 2005, Grainger had 16,732 employees, of whom 14,297 were full-time and 2,435 were part-time or temporary. Grainger has never had a major work stoppage and considers employee relations to be good.

Web Site Access to Company Reports

Grainger makes available, free of charge, through its Web site, its Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements and amendments to those reports, as soon as reasonably practicable after this material is electronically filed with or furnished to the Securities and Exchange Commission. This material may be accessed by visiting grainger.com/investor.

Item 1A: Risk Factors

The following is a discussion of significant risk factors relevant to Grainger's business that could adversely affect its financial condition or results of operations.

A slowdown in the economy could negatively impact Grainger's sales growth. Economic and industry trends affect Grainger's business environment. Grainger's sales growth has tended to correlate with commercial activity, manufacturing output and non-farm employment levels. Thus, a slowdown in economic activity could negatively impact Grainger's sales growth.

The facilities maintenance industry is a highly fragmented industry, and competition could result in a decreased demand for Grainger's products. There are several large competitors in the industry, although most of the market is served by small local and regional competitors. Grainger faces competition in all markets it serves, from manufacturers (including some of its own suppliers) that sell directly to certain segments of the market, wholesale distributors, catalog houses and certain retail enterprises. Competitive pressures could adversely affect Grainger's sales and profitability.

Unexpected product shortages could negatively impact customer relationships, resulting in an adverse impact on results of operations. Grainger's competitive strengths include product selection and availability. Products are purchased from more than 1,200 key suppliers, no one of which accounts for more than 10% of purchases. Historically, no significant difficulty has been encountered with respect to sources of supply. If Grainger were to experience difficulty in obtaining products, there could be a short-term adverse affect on results of operations and a longer-term adverse effect on customer relationships and reputation. In addition, Grainger has strategic relationships with key vendors. In the event Grainger was unable to maintain those relations, there might be a loss of competitive pricing advantages which could in turn adversely affect results of operations.

A delay in the implementation of Grainger's multiyear market expansion program could negatively affect anticipated future sales growth. In 2004, Grainger launched a multiyear market expansion program to strengthen its presence in top metropolitan markets and better position itself to serve the local customer. The program is being implemented in these markets in a phased approach. The success of the market expansion program is expected to be a driver of growth in 2006 and beyond. A delay in the implementation of the program or lower than projected results from the program could negatively impact anticipated future sales growth.

The addition of new product lines could impact future sales growth. Grainger may, from time to time, expand the breadth of its offerings by increasing the number of products it distributes. The success of these expansions will depend on Grainger's ability to accurately forecast market demand and to obtain product from suppliers.

Interruptions in the proper functioning of information systems could disrupt operations and cause unanticipated increases in costs or decreases in revenues, or both. The proper functioning of Grainger's information systems is critical to the successful operation of its business. Although Grainger's information systems are protected through physical and software safeguards and remote processing capabilities exist, information systems are still vulnerable to natural disasters, power losses, telecommunication failures and other problems. If critical information systems fail or are otherwise unavailable, Grainger's ability to process orders, identify business opportunities, maintain proper levels of inventories, collect accounts receivable and pay expenses could be adversely affected. In January 2006, Grainger installed an upgraded SAP branch operating system and replaced its legacy information systems for the U.S. branch-based businesses. Implementation of this system at other Grainger businesses is scheduled for future years.

Item 1B: Unresolved Staff Comments

None.

Item 2: Properties

As of December 31, 2005, Grainger's owned and leased facilities totaled 18,452,000 square feet, an increase of approximately 3% from December 31, 2004. This increase primarily related to the market expansion program. Industrial Supply and Acklands accounted for the majority of the total square footage. Industrial Supply facilities are located throughout the United States and Acklands facilities are located throughout Canada.

Industrial Supply branches range in size from 1,200 to 109,000 square feet and average approximately 20,000 square feet. Most are located in or near major metropolitan areas with many located in industrial parks. Typically, a branch is on one floor, is of masonry construction, consists primarily of warehouse space, sales areas and offices and has off-the-street parking for customers and employees. Grainger believes that its properties are generally in good condition and well maintained.

A brief description of significant facilities follows:

Location	Facility and Use (5)	Size in Square Feet
Chicago Area (1)	Headquarters and General Offices	1,191,000
United States (1)	Ten Distribution Centers	5,237,000
United States (1) (2)	416 Industrial Supply branch locations	8,386,000
Canada (3)	165 Acklands facilities	2,089,000
U.S. and International (4)	Other facilities	1,549,000
	Total Square Feet	18,452,000

(1) These facilities are either owned or leased with most leases expiring between 2006 and 2012.
(2) Industrial Supply branches consist of 283 owned and 133 leased properties.
(3) Acklands facilities consist of general offices, distribution centers and branches, of which 53 are owned and 112 leased.
(4) Other facilities primarily include locations for Lab Safety, Puerto Rico, Mexico, China and properties under construction.
(5) Owned facilities are not subject to any mortgages.

Item 3: Legal Proceedings

Grainger 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 Grainger. As of January 23, 2006, Grainger is named in cases filed on behalf of approximately 3,400 plaintiffs in which there is an allegation of exposure to asbestos and/or silica. In addition, five cases alleging exposure to cotton dust were amended during 2004 to add allegations relating to asbestos; as of January 23, 2006, approximately 1,300 plaintiffs in these cases are alleging asbestos exposure.

Grainger has denied, or intends to deny, the allegations in all of the above-described lawsuits. In 2005, lawsuits relating to asbestos and/or silica and involving approximately 700 plaintiffs were dismissed with respect to Grainger, typically based on the lack of product identification. If a specific product distributed by Grainger is identified in any of these lawsuits, Grainger would attempt to exercise indemnification remedies against the product manufacturer. In addition, Grainger believes that a substantial number of these claims are covered by insurance. Grainger is engaged in active discussions with its insurance carriers regarding the scope and amount of coverage. While Grainger 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 Grainger's consolidated financial position or results of operations.

In its Form 10-Q for the quarter ended September 30, 2005, Grainger reported a proceeding against Grainger's Canadian subsidiary, Acklands – Grainger Inc. (Acklands), for alleged violations of the Canadian Environmental Protection Act, 1999. In November, 2005, Acklands resolved this matter by entering into an environmental protection alternative measures (EPAM) agreement. The agreement requires Acklands to, among other things, pay C$150,000 to the Environment Damages Fund administered by Environment Canada.

In addition to the foregoing, from time to time Grainger 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 Grainger 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 Grainger's consolidated financial position or results of operations.

Item 4: Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of security holders during the fourth quarter of 2005.

Executive Officers

Following is information about the Executive Officers of Grainger including age as of February 1, 2006. Executive Officers of Grainger generally serve until the next annual election of officers, or until earlier resignation or removal.

Name and Age	Positions and Offices Held and Principal Occupations and Employment During the Past Five Years
Judith E. Andringa (45)	Vice President and Controller. Before joining Grainger in 2002, she was Controller of the Foodservice Division of Kraft Foods, Inc., a position assumed in 2000 after serving Kraft as Director of Finance, Marketing Services Group.
Nancy A. Hobor (59)	Senior Vice President (formerly Vice President), Communications and Investor Relations, a position assumed in 1999.
John L. Howard (48)	Senior Vice President and General Counsel, a position assumed in 2000.
Richard L. Keyser (63)	Chairman of the Board, a position assumed in 1997, and Chief Executive Officer, a position assumed in 1995.
Larry J. Loizzo (51)	Senior Vice President (formerly Vice President) of Grainger, a position assumed in 2003, and President of Lab Safety Supply, Inc., a position assumed in 1996.
P. Ogden Loux (63)	Senior Vice President, Finance and Chief Financial Officer, a position assumed in 1997.
James T. Ryan (47)	Group President, a position assumed in April 2004 after serving as Executive Vice President, Marketing, Sales and Service (for Grainger Industrial Supply). Before assuming the last-mentioned position in 2001, he served as Vice President of Grainger and President of grainger.com.

PART II

Item 5: Market for Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities

Market Information and Dividends

Grainger's common stock is traded on the New York Stock Exchange and the Chicago Stock Exchange, with the ticker symbol GWW. The high and low sales prices for the common stock and the dividends declared and paid for each calendar quarter during 2005 and 2004 are shown below.

		Prices		
	Quarters	High	Low	Dividends
2005	First	$67.25	$59.85	$0.200
	Second	63.38	51.65	0.240
	Third	66.19	53.10	0.240
	Fourth	72.45	60.50	0.240
	Year	$72.45	$51.65	$0.920
2004	First	$49.02	$45.00	$0.185
	Second	57.66	47.55	0.200
	Third	58.90	50.33	0.200
	Fourth	66.99	56.26	0.200
	Year	$66.99	$45.00	$0.785

Holders

The approximate number of shareholders of record of Grainger's common stock as of January 31, 2006 was 1,200.

Issuer Purchases of Equity Securities — Fourth Quarter

Period	Total Number of Shares Purchased (A)	Average Price Paid per Share (B)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (C)	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
Oct. 1 – Oct. 31	74,972	$62.94	67,600	4,927,100 shares
Nov. 1 – Nov. 30	102,300	$66.92	102,300	4,824,800 shares
Dec. 1 – Dec. 31	116,400	$70.25	116,400	4,708,400 shares
Total	293,672	$67.34	286,300	

(A) The total number of shares purchased includes Grainger's retention of 7,372 shares to satisfy tax withholding obligations in connection with the vesting of employee restricted stock awards.

(B) Average price paid per share includes any commissions paid and includes only those amounts related to purchases as part of publicly announced plans or programs. Activity is reported on a settlement date basis.

(C) Purchases were made pursuant to a share repurchase program approved by Grainger's Board of Directors. As reported in Grainger's Form 10-Q for the quarter ended September 30, 2002, which was filed on November 11, 2002, authority under the program was restored to 10 million shares on October 30, 2002. The program has no specified expiration date. No share repurchase plan or program expired, or was terminated, during the period covered by this report.

Other

On May 20, 2005, Grainger timely submitted to the New York Stock Exchange (NYSE) an Annual CEO Certification, in which Grainger's Chief Executive Officer certified that he was not aware of any violation by Grainger of the NYSE's corporate governance listing standards as of the date of the certification.

Item 6: Selected Financial Data

	2005	2004	2003	2002	2001
	(In thousands of dollars, except for per share amounts)				
Net sales	$5,526,636	$5,049,785	$4,667,014	$4,643,898	$4,754,317
Net earnings	346,324	286,923	226,971	211,567	174,530
Net earnings per basic share	3.87	3.18	2.50	2.30	1.87
Net earnings per diluted share	3.78	3.13	2.46	2.24	1.84
Total assets	3,107,921	2,809,573	2,624,678	2,437,448	2,331,246
Long-term debt (less current maturities)	4,895	—	4,895	119,693	118,219
Cash dividends paid per share	$ 0.920	$ 0.785	$ 0.735	$ 0.715	$ 0.695

The results for 2005 included an effective tax rate, excluding the effect of equity in unconsolidated entities, of 35.2%. The 2005 rate included tax benefits related to a favorable revision to the estimate of income taxes for various state taxing jurisdictions and the resolution of certain federal and state tax contingencies. These benefits increased diluted earnings per share by $0.10.

The results for 2004 included an effective tax rate, excluding the effect of equity in unconsolidated entities, of 35.6%, which was down from 40.0% in the prior year. The lower tax rate resulted in an increase of $0.21 per diluted share. The tax rate reduction was primarily due to a lower tax rate in Canada, the realization of tax benefits related to operations in Mexico and to capital losses, the recognition of tax benefits from the "Medicare Prescription Drug, Improvement and Modernization Act of 2003" (the Medicare Act) and the resolution of certain federal and state tax contingencies.

The results for 2002 included an after-tax gain on the sale of securities of $4.5 million, or $0.04 per diluted share, and an after-tax gain on the reduction of restructuring reserves established for the shutdown of the Material Logic business of $1.2 million, or $0.01 per diluted share. These were offset by the cumulative effect of a change in accounting for the write-down of goodwill of $23.9 million after-tax, or $0.26 per diluted share, related to Grainger's Canadian subsidiary.

The results for 2001 included an after-tax charge of $36.6 million, or $0.39 per diluted share, related to the restructuring charge established in connection with the closing of the Material Logic business and the write-down of investments in other digital enterprises.

For further information see **“Item 7: Management’s Discussion and Analysis of Financial Condition and Results of Operations”** and Note 4 to the Consolidated Financial Statements.

Item 7: Management’s Discussion and Analysis of Financial Condition and Results of Operations

Overview

General. Grainger is the leading broad-line supplier of facilities maintenance and other related products in North America. For each of the three years presented in this Annual Report on Form 10-K for the year ended December 31, 2005, Grainger reports its operating results in two segments: Branch-based Distribution and Lab Safety. Grainger distributes a wide range of products used by businesses and institutions to keep their facilities and equipment up and running. Grainger uses a multichannel business model to provide customers with a range of options for finding and purchasing products through a network of branches, field sales forces, direct marketing including catalogs, and a variety of electronic and Internet channels. Grainger serves customers through a network of 589 branches, 18 distribution centers and multiple Web sites.

Effective January 1, 2005, Grainger’s Integrated Supply business no longer entered into new contracts for on-site integrated purchasing and tool crib management services. It was merged into Grainger’s Industrial Supply division within the Branch-based Distribution segment. Grainger Industrial Supply is fulfilling existing Integrated Supply contracts. As such, in 2005 Integrated Supply was no longer reported as a separate segment and Grainger reported its operating results in two segments: Branch-based Distribution and Lab Safety.

Business Environment. Several economic factors and industry trends shape Grainger’s business environment. The current overall economy and leading economic indicators forecast by economists provide insight into anticipated economic factors for the near term and help in forming the development of projections for the upcoming year. At the start of 2006, the Consensus Forecast-USA predicted GDP and Industrial Production growth of 3.4 percent for 2006, although preliminary fourth quarter 2005 GDP estimates reflected a slowdown from prior quarters.

In 2005, Grainger benefited from the economic recovery in the United States. Grainger’s sales correlate positively with production growth. With the improvement in Industrial Production and general growth in the economy, Grainger realized an increase in sales across all customer segments. Grainger’s sales also tend to increase when non-farm payrolls grow, especially during economic recoveries. Non-farm payrolls increased approximately 2%, on average, in 2005 over 2004. For 2005, Grainger benefited from the combination of increased Industrial Production and non-farm payroll growth.

The light and heavy manufacturing customer segments, which comprised over 25% of Grainger’s total 2005 sales, have historically correlated with manufacturing employment levels and manufacturing production. Manufacturing employment levels were flat during 2005, however manufacturing output increased almost 4%. This contributed to almost double-digit sales growth in the light and heavy manufacturing customer segments for Grainger in 2005. Economic forecasts suggest that the manufacturing sector should continue to expand in 2006.

In 2004, Grainger launched a multiyear initiative to strengthen its presence in top metropolitan markets and better position itself to serve the local customer. The market expansion program contributed to the sales growth in 2005 and is expected to be a driver of growth in 2006 and beyond. The first phase of the market expansion program was completed in 2005. Phases two through four were in progress at December 31, 2005. Additional phases are scheduled for 2006 and beyond.

Customer buying behavior is also important in Grainger’s business environment. Grainger believes that customers will continue to focus on reducing their cost to procure facilities maintenance products. Consequently, Grainger is increasing information available to employees for improved service to customers by installing an upgraded SAP branch operating system and replacing its legacy information systems with a new integrated software package also provided by SAP, in the U.S. branch-based businesses, effective January 30, 2006.

Grainger’s financial strength, including its low debt and strong cash flow, positions it to fund acquisitions and major initiatives, improve effectiveness and accelerate top line growth. Capital spending in 2005 related to the market expansion program and SAP initiative was approximately $88 million, with total capital expenditures of more than $157 million.

For 2006, Grainger anticipates total capital expenditures of $140 million to $175 million. Grainger intends to continue its investment in the market expansion program and information technology enhancements with spending planned for the following major projects:

- $50 million to $60 million for continued market expansion;
- $15 million to $20 million for information technology;
- $20 million to $22 million for international expansion; and
- $5 million to $10 million for product line expansion.

Lease or purchase decisions, based on availability of facilities, may affect the timing of capital expenditures associated with the market expansion program.

Matters Affecting Comparability. Grainger's operating results for 2005 included the operating results for AW Direct from the acquisition date of January 14, 2005. AW Direct's results are included in the Lab Safety Segment.

Grainger's operating results for 2004 included a full year of operating results of Gempler's. Grainger's operating results for 2003 included the results of Gempler's only from the acquisition date of April 14, 2003. Gempler's results are included in the Lab Safety Segment.

Results of Operations

The following table is included as an aid to understanding changes in Grainger's Consolidated Statements of Earnings:

	For the Years Ended December 31, Items in Consolidated Statements of Earnings				
	As a Percent of Net Sales			Percent Increase/(Decrease) from Prior Year	
	2005	2004	2003	2005	2004
Net sales	100.0%	100.0%	100.0%	9.4%	8.2%
Cost of merchandise sold	60.9	62.2	63.8	7.1	5.6
Gross profit	39.1	37.8	36.2	13.4	12.7
Operating expenses	29.7	29.1	27.9	12.1	12.5
Operating earnings	9.4	8.7	8.3	17.6	13.5
Other income (expense)	0.3	0.1	(0.1)	252.3	(149.9)
Income taxes	3.4	3.1	3.3	17.8	2.7
Net earnings	6.3%	5.7%	4.9%	20.7%	26.4%

2005 Compared to 2004

Grainger's net sales for 2005 of $5,526.6 million were up 9.4% versus 2004. The increase in net sales was led by strong sales to the commercial, government, manufacturing and natural resource sectors. Also contributing to the improvement was growth from the U.S. market expansion program. Partially offsetting these sales improvements was the negative effect of the wind-down of integrated supply and related automotive contracts.

The gross profit margin of 39.1% in 2005 improved 1.3 percentage points over the gross profit margin of 37.8% in 2004, principally due to selling price category mix and the positive effect of product mix, including the global sourcing of products. The major driver of the improvement in the selling price category mix was reduced sales to integrated supply and automotive customers, which carry lower than average gross profit margins.

Grainger's operating earnings of $519.0 million in 2005 increased $77.7 million, or 17.6%, over the prior year. The operating margin of 9.4% in 2005 improved 0.7 percentage point over 2004, as the combined effect of increased sales and improvement in gross profit margin exceeded the increase in operating expenses. Operating expenses were up 12.1% in 2005 principally due to higher variable compensation and benefits associated with the improved performance for the year, as well as to incremental costs related to the market expansion and information technology programs.

In 2005, net earnings of $346.3 million increased $59.4 million, or 20.7%, over the prior year. The growth in net earnings was due to the improvement in operating earnings, higher net interest income and a lower tax rate. Diluted earnings per share for 2005 of $3.78 were 20.8% higher than the $3.13 for 2004.

Segment Analysis

The following comments at the segment level include external and intersegment net sales and operating earnings. Comments at the business unit level include external and inter- and intrasegment net sales and operating earnings. See Note 19 to the Consolidated Financial Statements.

Branch-based Distribution

Net sales of $5,150.2 million in 2005 increased 9.2% over 2004 net sales of $4,716.2 million. Sales in the United States were up 8.4% over the prior year. All customer segments increased, with the strongest sales growth in the commercial, government and manufacturing sectors. National account sales, which include all customer segments, were up 11.9%. The wind-down of integrated supply and automotive contracts reduced sales growth by approximately 2 percentage points.

In 2004, the Company launched a multiyear market expansion program to strengthen its presence in top metropolitan markets and better position itself to serve local customers. Phases 1 through 3 include ten markets. As of the fourth quarter of 2005, the Company had begun Phase 4 of the program. Additional phases are scheduled for 2006 and beyond.

	Sales Increase 2005 vs. 2004	Estimate of Completion*
Phase 1 (Atlanta, Denver, Seattle)	10%	100%
Phase 2 (Four markets in Southern California)	14%	90%
Phase 3 (Houston, St. Louis, Tampa)	19%	70%

* Phases are reported once they reach 50% completion. Completion occurs when a new branch opens or a branch expansion or remodeling is finished.

Overall, market expansion contributed approximately 1 percentage point to the segment sales growth. The sales growth in Phase 1 was negatively affected in the Denver market due to lower sales to one large customer. Excluding the effect of this customer, sales in Phase 1 were up 13%.

Net sales in Canada were 15.6% higher in 2005 than in 2004, benefiting from a favorable Canadian exchange rate. In local currency, sales increased 7.7%, primarily due to strength in the Canadian economy driven by the natural resources sector. Sales in Mexico were up 18.6% in 2005 as compared to 2004, driven by a strong local economy, expanded telesales operations and improved sales to national accounts.

Cost of merchandise sold of $3,149.5 million increased $199.4 million, or 6.8%, over 2004 due to increased volume. Gross profit margins improved 1.4 percentage points to 38.8% in 2005 from 37.4% in 2004. Contributing to the improvement in gross profit margin were selling price category mix and the positive effect of product mix, which included the global sourcing of additional products. The major driver of the improvement in selling price category mix was reduced sales to integrated supply and automotive customers, which carry lower than average gross margins.

Operating expenses for the Branch-based Distribution businesses increased 12.6% in 2005. Operating expenses were up primarily as a result of payroll and benefits costs. Payroll increases were due to higher headcount to support strategic initiatives including the market expansion program and information technology upgrades. In addition, sales commissions and profit sharing accruals increased due to the improved 2005 performance. Partially offsetting these increases was lower bad debt expense, the result of improved collections and reduced write-offs.

In 2005, operating earnings of $536.6 million increased by $71.1 million, or 15.3%, over 2004. The improvement was the result of sales growth, combined with the improvement in gross profit margin, and was partially offset by operating expenses, which grew faster than sales.

Lab Safety

Net sales at Lab Safety were $380.1 million in 2005, an increase of $43.4 million, or 12.9%, when compared with $336.7 million of sales in 2004. Higher sales were principally driven by incremental sales from AW Direct, which was acquired on January 14, 2005. Excluding AW Direct, sales increased 4.0% over 2004.

The gross profit margin of 42.5% increased 0.7 percentage point when compared to the gross profit margin of 41.8% for 2004. Contributing to the improvement was a favorable selling price category mix, partially offset by the negative effect of AW Direct sales, which carry lower gross profit margins.

Operating expenses were $109.0 million in 2005, up $13.7 million, or 14.3%, over 2004. The increase over the prior year was principally driven by higher variable compensation expense related to the strong performance for the year and higher catalog media costs, partially offset by lower data processing expense related to fully amortized enterprise software. Also contributing to the increase were costs associated with the AW Direct acquisition.

Operating earnings of $52.7 million were up 15.9% in 2005 over 2004, resulting primarily from the increase in sales and the improved gross profit margin, partially offset by increased operating expenses.

Other Income and Expense

Other income and expense was $13.7 million of income in 2005, an improvement of $9.8 million as compared with $3.9 million of income in 2004. The following table summarizes the components of other income and expense:

	For the Years Ended December 31,	
	2005	2004
	(In thousands of dollars)	
Other income and (expense):		
Interest income (expense) – net	$11,019	$ 1,988
Equity in income of unconsolidated entities – net	2,809	996
Gain on sale of unconsolidated entity	—	750
Unclassified – net:		
Gain on sale of investment securities	—	50
Other	(143)	101
	$13,685	$ 3,885

The improvement in other income and expense in 2005 over 2004 was primarily attributable to higher interest income and lower interest expense and improvement in the results of unconsolidated entities. The increase in interest income in 2005 was primarily the result of higher interest rates. Interest expense decreased due to the payment of the cross-currency debt swap in September 2004.

Income Taxes

Income taxes of $186.4 million in 2005 increased 17.8% as compared with $158.2 million in 2004.

Grainger's effective tax rates were 35.0% and 35.5% in 2005 and 2004, respectively. Excluding the effect of equity in unconsolidated entities, which is recorded net of tax, the effective income tax rates were 35.2% for 2005 and 35.6% for 2004.

The 2005 tax rate included tax benefits related to a favorable revision to the estimate of income taxes for various state and local taxing jurisdictions and the resolution of certain federal and state tax contingencies.

The tax rate in 2004 included the realization of tax benefits related to operations in Mexico and to capital losses, the recognition of tax benefits from the Medicare Act and the resolution of certain federal and state tax contingencies.

For 2006, Grainger is projecting its estimated effective tax rate to be 38.9%, excluding the effects of equity in unconsolidated entities.

2004 Compared to 2003

Grainger's net sales for 2004 of $5,049.8 million were up 8.2% versus 2003. The increase in net sales was a result of the strengthening in the manufacturing and commercial sectors. Full year results also benefited from the completion of the logistics network upgrade, which improved product availability, as well as from the launch of the market expansion project, an expanded sales force and new communication technology in the U.S. branches. The increase in net sales was realized in the Branch-based Distribution and Lab Safety segments of the business.

The gross profit margin of 37.8% in 2004 improved 1.6 percentage points over the gross profit margin of 36.2% in 2003, principally due to product cost reduction programs, including the global sourcing of products, combined with selected price increases in 2004 and the positive effect of product mix. These margin improvements were partially offset by unfavorable changes in selling price category mix.

Grainger's operating earnings of $441.3 million in 2004 increased $52.4 million, or 13.5%, over the prior year. The operating margin of 8.7% in 2004 improved 0.4 percentage point over 2003, as the combined effect of increased sales and improvement in gross profit margin exceeded the increase in operating expenses. Operating expenses were up 12.5% in 2004 principally due to higher variable compensation and benefits associated with the improved performance for the year, as well as to incremental costs related to the market expansion and information technology programs.

In 2004, net earnings of $286.9 million increased $60.0 million, or 26.4%, over the prior year. The growth in net earnings was due to the improvement in operating earnings, higher interest income and a lower tax rate. Diluted earnings per share for 2004 of $3.13 were 27.2% higher than the $2.46 for 2003.

Segment Analysis

The following comments at the segment level include external and intersegment net sales and operating earnings. Comments at the business unit level include external and inter- and intrasegment net sales and operating earnings. See Note 19 to the Consolidated Financial Statements.

Branch-based Distribution

Net sales of $4,716.2 million in 2004 increased 8.0% over 2003 net sales of $4,365.5 million. Sales in the United States were up 8.2% over the prior year. All customer segments increased, with the strongest sales growth in the manufacturing and commercial sectors. National account sales, which include all customer segments, were up 12%. Sales to government accounts were up 5% primarily due to increased sales to the U.S. Postal Service and to federal, state and local governments.

Net sales in Canada were 11.1% higher in 2004 than in 2003, benefiting primarily from a favorable Canadian exchange rate. In local currency, sales increased 3.3%, primarily due to a strengthening in the Canadian economy in the second half of the year driven by the natural resources sector. Sales in Mexico were up 15.4% in 2004 as compared to 2003, driven by an improving local economy, expanded telesales operations and several branch facility enhancements during the year.

Cost of merchandise sold of $2,950.1 million increased $147.2 million, or 5.3%, over 2003 due to increased volume, while gross profit margins improved 1.7 percentage points to 37.5% in 2004 from 35.8% in 2003. Contributing to the improvement in gross profit margin were product cost reduction programs, which included the global sourcing of additional products, combined with selected price increases and the positive effect of product mix. These margin improvements were partially offset by unfavorable changes in selling price category mix.

Operating expenses for the Branch-based Distribution businesses increased 11.5% in 2004. Operating expenses were up primarily as a result of higher sales commissions and bonus and profit sharing accruals associated with the improved 2004 performance, as well as increased costs related to strategic initiatives such as the market expansion program and technology upgrades. Partially offsetting these increases was improved productivity achieved from the redesigned logistics network.

In 2004, operating earnings of $465.5 million increased by $69.8 million, or 17.6%, over 2003. The effect of sales growth, combined with the improvement in gross profit margin, more than offset the increase in operating expenses.

Lab Safety

Net sales at Lab Safety were $336.7 million in 2004, an increase of $31.2 million, or 10.2%, when compared with $305.5 million of sales in 2003. Higher sales were principally driven by growth in nonsafety products. Sales through Lab Safety's Web sites were up 26.1% in 2004 over 2003. Also contributing to the year-over-year increase were incremental sales from Gempler's, which was acquired on April 14, 2003. Excluding Gempler's, sales increased 6.1% over 2003.

The gross profit margin of 41.8% decreased 0.4 percentage point when compared to the gross profit margin of 42.2% for 2003. Contributing to the decline was the negative effect of selling price category mix combined with the effect of a full year of Gempler's sales, which carry lower than average gross profit margins.

Operating expenses were $95.3 million in 2004, up $8.4 million, or 9.6%, over 2003. The increase over the prior year was principally driven by higher variable compensation expense related to the strong performance for the year, higher catalog media costs and higher benefits expenses from increases in healthcare costs. Also contributing to the increase were costs associated with Gempler's for a full year in 2004 versus a partial year in 2003.

Operating earnings of $45.5 million were up 8.6% in 2004 over 2003, resulting primarily from the increase in sales, partially offset by the lower gross profit margin and increased operating expenses.

Other Income and Expense

Other income and expense was $3.9 million of income in 2004, an improvement of $11.7 million as compared with $7.8 million of expense in 2003. The following table summarizes the components of other income and expense:

	For the Years Ended December 31, 2004	For the Years Ended December 31, 2003
	(In thousands of dollars)	
Other income and (expense)		
Interest income (expense) – net	$ 1,988	$(2,668)
Equity in income (loss) of unconsolidated entities – net	996	(2,288)
Gain on sale of unconsolidated entity	750	—
Write-off of investments in unconsolidated entities	—	(1,921)
Unclassified – net:		
Gains on sales of investment securities	50	1,208
Write-down of investment securities	—	(1,614)
Other	101	(495)
	$ 3,885	$(7,778)

The improvement in other income and expense in 2004 over 2003 was primarily attributable to net interest income in 2004 versus net interest expense in 2003, as well as a $3.3 million improvement in the results of unconsolidated entities. The change to net interest income in 2004 from net interest expense in 2003 was due to the combination of higher interest rates and invested balances, together with the reduction in outstanding long-term debt balances. Additionally, 2003 included $1.9 million in expense for the write-off of investments in two Asian joint ventures and $1.6 million in expense for the write-down of investment securities. See Note 7 to the Consolidated Financial Statements.

Income Taxes

Income taxes of $158.2 million in 2004 increased 2.7% as compared with $154.1 million in 2003.

Grainger's effective tax rates were 35.5% and 40.4% in 2004 and 2003, respectively. Excluding the effect of equity in unconsolidated entities and the write-off of these investments, which are recorded net of tax, the effective income tax rates were 35.6% for 2004 and 40.0% for 2003. The tax rate reduction in 2004 was primarily due to a lower tax in Canada, the realization of tax benefits related to operations in Mexico and to capital losses, the recognition of tax benefits from the Medicare Act and the resolution of certain federal and state tax contingencies.

Financial Condition

Grainger expects its strong working capital position and cash flows from operations to continue, allowing it to fund its operations including growth initiatives and capital expenditures, as well as to repurchase shares and pay cash dividends at or above historical levels.

Cash Flow

Net cash flows from operations of $432.5 million in 2005, $406.5 million in 2004 and $394.1 million in 2003 continued to improve Grainger's financial position and serve as the primary source of funding. Net cash provided by operations increased $26.0 million in 2005 over 2004 driven primarily by increased net earnings. The Change in operating assets and liabilities – net of business acquisition and joint venture contributions used cash of $57.1 million in 2005. The use of cash was primarily driven by increases in inventory and trade accounts receivable, which were up due to higher inventory purchases and sales in December. These changes were partially offset by an increase in trade accounts payable due to the higher inventory purchases and increases in profit sharing and compensation related accruals, driven by an improved 2005 performance. The increase in net cash flows from operations from 2003 to 2004 was primarily attributable to increased net earnings and an improvement in working capital management. Increases in current liabilities and trade accounts payable were partially offset by increases in inventory and accounts receivables.

Net cash flows used in investing activities were $163.0 million, $142.4 million and $105.3 million for 2005, 2004 and 2003, respectively. Capital expenditures for property, buildings, equipment and capitalized software were $157.2 million, $160.8 million and $80.5 million in 2005, 2004 and 2003, respectively. Additional information regarding capital spending is detailed in the ***Capital Expenditures*** section below. In 2005, Grainger also invested $24.8 million to purchase AW Direct, which is part of the Lab Safety segment. The results of operations for AW Direct have been included in the consolidated financial statements since the acquisition date of January 14, 2005.

Net cash flows used in financing activities for 2005, 2004 and 2003 were $154.1 million, $240.6 million and $97.9 million, respectively. Grainger's funding of treasury stock purchases increased $36.6 million in 2005, as Grainger repurchased 2,404,400 shares, compared with 2,001,000 shares in 2004. Treasury stock purchases were 918,300 in 2003. As of December 31, 2005, approximately 4.7 million shares of common stock remained available under Grainger's repurchase authorization. Dividends paid to shareholders were $82.7 million in 2005, $71.2 million in 2004 and $67.3 million in 2003. Partially offsetting these cash outlays were proceeds from stock options exercised of $66.0 million, $72.3 million and $15.2 million for 2005, 2004 and 2003, respectively. During 2004, Grainger liquidated its cross-currency swap and related commercial paper debt with payments totaling $140.8 million.

Working Capital

Internally generated funds have been the primary source of working capital and for funds used in business expansion, supplemented by debt as circumstances dictated. In addition, funds were expended for facilities optimization and enhancements to support growth initiatives, as well as for business and systems development and other infrastructure improvements.

Working capital was $1,270.9 million at December 31, 2005, compared with $1,092.3 million at December 31, 2004, and $926.8 million at December 31, 2003. At these dates, the ratio of current assets to current liabilities was 2.7, 2.6 and 2.3, respectively. The current ratio increased in 2004 principally due to Grainger's liquidation of the cross-currency swap and related commercial paper debt that had been classified in current liabilities in 2004.

Capital Expenditures

In each of the past three years, a portion of operating cash flow has been used for additions to property, buildings, equipment and capitalized software as summarized in the following table:

	For the Years Ended December 31,		
	2005	2004	2003
	(In thousands of dollars)		
Land, buildings, structures and improvements	$ 52,955	$ 41,929	$ 24,960
Furniture, fixtures, machinery and equipment	59,342	86,347	49,104
Subtotal	112,297	128,276	74,064
Capitalized software	44,950	32,482	6,422
Total	$157,247	$160,758	$ 80,486

In both 2005 and 2004, Grainger's investments included the market expansion program, which is designed to re-align branches in several metropolitan markets, ongoing SAP initiatives, an upgrade of the branch communication systems and expenditures related to Canadian branch and systems projects, as well as the normal, recurring replacement of equipment. Capital expenditures in 2003 related to Grainger's investment in its logistics network, which was completed in March 2004, spending for information technology upgrades, as well as the normal, recurring replacement of equipment.

Capital expenditures are expected to range between $140 million to $175 million in 2006 and include investments for the ongoing market expansion program, information technology and Canadian branch programs, international expansion, as well as other general projects including the normal, recurring replacement of equipment. Grainger expects to fund 2006 capital investments from operating cash flows, which Grainger believes will remain strong.

Debt

Grainger maintains a debt ratio and liquidity position that provides flexibility in funding working capital needs and long-term cash requirements. In addition to internally generated funds, Grainger has various sources of financing available, including commercial paper sales and bank borrowings under lines of credit. At December 31, 2005, Grainger's long-term debt rating by Standard & Poor's was AA+. Grainger's available lines of credit, as further discussed in Note 10 to the Consolidated Financial Statements, were $250.0 million at December 31, 2005 and 2004, and $265.4 million at December 31, 2003. Total debt as a percent of total capitalization was 0.4%, 0.5% and 7.5% as of the same dates.

Grainger entered into a two-year cross-currency swap on September 25, 2002. On September 27, 2004, the cross-currency swap and related commercial paper debt matured and were liquidated with payments totaling $140.8 million. See Note 12 to the Consolidated Financial Statements.

Grainger believes any circumstances that would trigger early payment or acceleration with respect to any outstanding debt securities would not have a material impact on its results of operations or financial condition. Certain holders of industrial revenue bonds have various rights to require Grainger to redeem these bonds, thus a portion are classified as Current maturities of long-term debt.

Commitments and Other Contractual Obligations

At December 31, 2005, Grainger's contractual obligations, including estimated payments due by period, are as follows:

	Payments Due by Period				
	Total Amounts Committed	Less than 1 Year	1 – 3 Years	4 – 5 Years	More than 5 Years
	(In thousands of dollars)				
Long-term debt obligations	$ 9,485	$ 4,590	$ —	$ 4,895	$ —
Operating lease obligations	120,179	25,620	55,774	19,768	19,017
Purchase obligations:					
Uncompleted additions to property, buildings and equipment	36,034	36,034	—	—	—
Commitments to purchase inventory	198,910	198,910	—	—	—
Other purchase obligations	119,108	68,671	49,647	790	—
Total	$ 483,716	$333,825	$105,421	$25,453	$ 19,017

Purchase obligations consist primarily of inventory purchases made in the normal course of business to meet operating needs. While purchase orders for both inventory purchases and noninventory purchases are generally cancelable without penalty, certain vendor agreements provide for cancellation fees or penalties depending on the terms of the contract.

The Commitments and Other Contractual Obligations table does not include $80.1 million of accrued employment-related benefits costs, of which $52.3 million is related to Grainger's postretirement benefits. These amounts are excluded because a portion of the projected benefit payments has already been funded by Grainger and the timing of future funding requirements is not known. See Note 11 to the Consolidated Financial Statements.

See also Notes 12 and 13 to the Consolidated Financial Statements.

Off-Balance Sheet Arrangements

Grainger does not have any material exposures to off-balance sheet arrangements. Grainger does not have any variable interest entities or activities that include nonexchange-traded contracts accounted for at fair value.

Critical Accounting Policies and Estimates

The preparation of financial statements, in conformity with accounting principles generally accepted in the United States of America, requires management to make judgments, estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses in the financial statements. Management bases its estimates on historical experience and other assumptions, which it believes are reasonable. If actual amounts are ultimately different from these estimates, the revisions are included in Grainger's results of operations for the period in which the actual amounts become known.

Accounting policies are considered critical when they require management to make assumptions about matters that are highly uncertain at the time the estimate is made and when different estimates than those management reasonably could have made have a material impact on the presentation of Grainger's financial condition, changes in financial condition or results of operations.

Note 2 to the Consolidated Financial Statements describes the significant accounting policies used in the preparation of the Consolidated Financial Statements. The most significant areas involving management judgments and estimates follow. Actual results in these areas could differ materially from management's estimates under different assumptions or conditions.

Postretirement Healthcare Benefits. Postretirement obligations and net periodic costs are dependent on assumptions and estimates used in calculating such amounts. The assumptions used include, among others, discount rates, assumed rates of return on plan assets and healthcare cost trend rates. Changes in assumptions (caused by conditions in equity markets or plan experience, for example) could have a material effect on Grainger's postretirement benefit obligations and expense, and could affect its results of operations and financial condition. These changes in assumptions may also affect voluntary decisions to make additional contributions to the trust established for funding the postretirement benefit obligation.

The discount rate assumptions used by management reflect the rates available on high-quality fixed income debt instruments as of December 31, the measurement date, of each year in accordance with Statement of Financial Accounting Standards (SFAS) No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions." A lower discount rate increases the present value of benefit obligations and net periodic postretirement benefit costs. As of December 31, 2005, Grainger reduced the discount rate used in the calculation of its postretirement plan obligation from 5.75% to 5.50% to reflect the decline in market interest rates. Grainger estimates that the reduction in the expected discount rate will decrease 2006 pretax earnings by approximately $0.8 million.

Grainger considers the long-term historical actual return on plan assets and the historical performance of the Standard & Poor's 500 Index to develop its expected long-term return on plan assets. In 2005, Grainger maintained the expected long-term rate of return on plan assets of 6.0% (net of tax at 40%) based on the historical average of long-term rates of return.

Grainger may terminate or modify the postretirement plan at any time, subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code, as amended. In the event the postretirement plan is terminated, all assets of the Group Benefit Trust inure to the benefit of the participants. The foregoing assumptions are based on the presumption that the postretirement plan will continue. Were the postretirement plan to terminate, different actuarial assumptions and other factors might be applicable.

While Grainger has used its best judgment in making assumptions and estimates, and believes such assumptions and estimates used are appropriate, changes to the assumptions may be required in future years as a result of actual experience and new trends and, therefore, may affect Grainger's retirement plan obligations and future expense.

For additional information concerning postretirement healthcare benefits, see Note 11 to the Consolidated Financial Statements.

Insurance Reserves. Grainger retains a significant portion of the risk of certain losses related to workers' compensation, general liability and property losses through the utilization of deductibles and self-insured retentions. There are also certain other risk areas for which Grainger does not maintain insurance.

Grainger is responsible for establishing policies on insurance reserves. Although it relies on outside parties to project future claims costs, it retains control over actuarial assumptions, including loss development factors and claim payment patterns. Grainger performs ongoing reviews of its insured and uninsured risks, which it uses to establish the appropriate reserve levels.

The use of assumptions in the analysis leads to fluctuations in required reserves over time. Any change in the required reserve balance is reflected in the current period's results of operations.

Allowance for Doubtful Accounts. Grainger uses several factors to estimate the allowance for uncollectible accounts receivable including the age of the receivables and the historical ratio of actual write-offs to the age of the receivables. The analyses performed 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.

Inventory Reserves. Grainger establishes inventory reserves for shrinkage and excess and obsolete inventory. Provisions for inventory shrinkage are based on historical experience to account for unmeasured usage or loss. Actual inventory shrinkage could be materially different from these estimates affecting Grainger's inventory values and cost of merchandise sold.

Grainger regularly reviews inventory to evaluate continued demand and identify any obsolete or excess quantities of inventory. Grainger records provisions for the difference between excess and obsolete inventory and its estimated realizable value. Estimated realizable value is based on anticipated future product demand, market conditions and liquidation values. Actual results differing from these projections could have a material effect on Grainger's results of operations.

Income Taxes. Grainger accounts for income taxes in accordance with SFAS No. 109, "Accounting for Income Taxes." Under SFAS No. 109, deferred tax assets and liabilities are determined based on the differences between the financial statement and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse. The tax balances and income tax expense recognized by Grainger are based on management's interpretations of the tax laws of multiple jurisdictions. Income tax expense reflects Grainger's best estimates and assumptions regarding, among other items, the level of future taxable income, interpretation of tax laws and tax planning opportunities. Future rulings by tax authorities and future changes in tax laws and their interpretation, changes in projected levels of taxable income and future tax planning strategies could impact the actual effective tax rate and tax balances recorded by Grainger.

Other. Other significant accounting policies, not involving the same level of measurement uncertainties as those discussed above, are nevertheless important to an understanding of the financial statements. Policies relating to revenue recognition, depreciation, intangibles, long-lived assets and warranties require judgments on complex matters that are often subject to multiple external sources of authoritative guidance such as the Financial Accounting Standards Board and the Securities and Exchange Commission. Possible changes in estimates or assumptions associated with these policies are not expected to have a material effect on the financial condition or results of operations of Grainger. More information on these additional accounting policies can be found in Note 2 to the Consolidated Financial Statements.

Inflation and Changing Prices

Inflation during the last three years has not had a significant effect on operations. The predominant use of the last-in, first-out (LIFO) method of accounting for inventories and accelerated depreciation methods for financial reporting and income tax purposes result in a substantial recognition of the effects of inflation in the financial statements.

The major impact of inflation is on buildings and improvements, where the gap between historic cost and replacement cost continues for these long-lived assets. The related depreciation expense associated with these assets increases if adjustments were to be made for the cumulative effect of inflation.

Grainger believes the most positive means to combat inflation and advance the interests of investors lies in the continued application of basic business principles, which include improving productivity, increasing working capital turnover and offering products and services which can command appropriate prices in the marketplace.

Forward-Looking Statements

This document contains forward-looking statements under the federal securities laws. The forward-looking statements relate to Grainger's expected future financial results and business plans, strategies and objectives and are not historical facts. They are often identified by qualifiers such as "will," "expects," "intends," "is likely," "anticipated," "scheduled," "believes," "positioned to," "continue," "estimates," "forecast," "predicting," "projection," "potential," "assumption" or similar expressions. There are risks and uncertainties the outcome of which could cause Grainger's results to differ materially from what is projected.

Factors that may affect forward-looking statements include the following: higher product costs or other expenses; a major loss of customers; increased competitive pricing pressure on Grainger's businesses; failure to develop or implement new technologies or other business strategies; the outcome of pending and future litigation and governmental proceedings; changes in laws and regulations; facilities disruptions or shutdowns; disruptions in transportation services; natural and other catastrophes; unanticipated weather conditions; and other difficulties in achieving or improving margins or financial performance.

Trends and projections could also be affected by general industry and market conditions, gross domestic product growth rates, general economic conditions including interest rate and currency rate fluctuations, global and other conflicts, employment levels and other factors.

Item 7A: Quantitative and Qualitative Disclosures About Market Risk

Grainger is exposed to foreign currency exchange risk related to its transactions, assets and liabilities denominated in foreign currencies. During a portion of 2004 and all of 2003, Grainger partially hedged its net Canadian dollar investment in Acklands with a cross-currency swap agreement. This agreement was terminated in 2004. See Note 12 to the Consolidated Financial Statements. For 2005, a uniform 10% strengthening of the U.S. dollar relative to foreign currencies that affect Grainger and its joint ventures would have resulted in a $1.6 million decrease in net income. Comparatively, in 2004 a uniform 10% strengthening of the U.S. dollar relative to foreign currencies that affect Grainger and its joint ventures would have resulted in a $0.9 million decrease in net income. A uniform 10% weakening of the U.S. dollar would have resulted in a $1.9 million increase in net income for 2005, as compared with an increase in net income of $1.1 million for 2004. This sensitivity analysis of the effects of changes in foreign currency exchange rates does not factor in potential changes in sales levels or local currency prices. Grainger does not hold derivatives for trading purposes.

Grainger is also exposed to interest rate risk in its debt portfolio. During 2005 and 2004, all of its long-term debt was variable rate debt. A one-percentage-point increase in interest rates paid by Grainger would have resulted in a decrease to income of approximately $0.1 million for 2005 and $0.7 million for 2004. A one-percentage-point decrease in interest rates would have resulted in an increase to income of approximately $0.1 million and $0.7 million for 2005 and 2004, respectively. This sensitivity analysis of the effects of changes in interest rates on long-term debt does not factor in potential changes in exchange rates or long-term debt levels. Grainger's level of interest rate risk has been reduced due to the liquidation of the cross-currency swap and related commercial paper debt during 2004. See Note 12 to the Consolidated Financial Statements.

Grainger is not exposed to commodity price risk since it purchases its goods for resale and does not purchase commodities directly.

Item 8: Financial Statements and Supplementary Data

The financial statements and supplementary data are included on pages 25 to 62. See the Index to Financial Statements and Supplementary Data on page 24.

Item 9: Changes in and Disagreements With Accountants on Accounting and Financial Disclosure

None.

Item 9A: Controls and Procedures

Disclosure Controls and Procedures

Grainger carried out an evaluation, under the supervision and with the participation of its management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of Grainger's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that Grainger's disclosure controls and procedures were effective as of the end of the period covered by this report.

Internal Control over Financial Reporting

(a) Management's Annual Report on Internal Control Over Financial Reporting

The management of W.W. Grainger, Inc. (Grainger) is responsible for establishing and maintaining adequate internal control over financial reporting. Grainger's internal control system was designed to provide reasonable assurance to Grainger's management and Board of Directors regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements under all potential conditions. Therefore, effective internal control over financial reporting provides only reasonable, and not absolute, assurance with respect to the preparation and presentation of financial statements.

Grainger's management assessed the effectiveness of Grainger's internal control over financial reporting as of December 31, 2005, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control – Integrated Framework*. Based on its assessment under that framework and the criteria established therein, Grainger's management concluded that Grainger's internal control over financial reporting was effective as of December 31, 2005.

Ernst & Young LLP, an independent registered public accounting firm, has audited management's assessment of the effectiveness of Grainger's internal control over financial reporting as of December 31, 2005, as stated in their report which is included herein.

(b) Attestation Report of the Registered Public Accounting Firm

The report from Ernst & Young LLP on its audit of management's assessment of the effectiveness of Grainger's internal control over financial reporting as of December 31, 2005, is included on page 26.

(c) Changes in Internal Control Over Financial Reporting

There were no changes in Grainger's internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, Grainger's internal control over financial reporting.

Item 9B: Other Information

None.

PART III

Item 10: Directors and Executive Officers of the Registrant

The information required by this item is incorporated by reference to Grainger's proxy statement relating to the annual meeting of shareholders to be held April 26, 2006, under the captions "Election of Directors," "Board of Directors and Board Committees" and "Section 16(a) Beneficial Ownership Reporting Compliance." Information required by this item regarding executive officers of Grainger is set forth in Part I of this report under the caption "Executive Officers."

Grainger has adopted a code of ethics that applies to the chief executive officer, chief financial officer and chief accounting officer. This code of ethics is incorporated into Grainger's business conduct guidelines for directors, officers and employees. Grainger intends to satisfy the annual disclosure requirement under Item 5.05 of Form 8-K relating to its code of ethics by posting such information on its Web site. A copy of the business conduct guidelines is available at www.grainger.com/investor and is also available in print without charge to any person upon request to Grainger's Corporate Secretary. Grainger has also adopted Operating Principles for the Board of Directors, which are available on its Web site and are available in print to any person who requests them.

Item 11: Executive Compensation

The information required by this item is incorporated by reference to Grainger's proxy statement relating to the annual meeting of shareholders to be held April 26, 2006, under the captions "Director Compensation" and "Executive Compensation."

Item 12: Security Ownership of Certain Beneficial Owners and Management

The information required by this item is incorporated by reference to Grainger's proxy statement relating to the annual meeting of shareholders to be held April 26, 2006, under the captions "Ownership of Grainger Stock" and "Equity Compensation Plans."

Item 13: Certain Relationships and Related Transactions

The information required by this item is incorporated by reference to Grainger's proxy statement relating to the annual meeting of shareholders to be held April 26, 2006, under the caption "Director Compensation."

Item 14: Principal Accounting Fees and Services

The information required by this item is incorporated by reference to Grainger's proxy statement relating to the annual meeting of shareholders to be held April 26, 2006, under the caption "Audit Fees and Audit Committee Pre-Approval Policies and Procedures."

PART IV

Item 15: Exhibits and Financial Statement Schedules

(a) 1. Financial Statements. See Index to Financial Statements and Supplementary Data.

2. Financial Statement Schedules. The schedules listed in Reg. 210.5-04 have been omitted because they are either not applicable or the required information is shown in the consolidated financial statements or notes thereto.

3. Exhibits:

(3) (a) Restated Articles of Incorporation, incorporated by reference to Exhibit 3(i) to Grainger's Quarterly Report on Form 10-Q for the quarter ended June 30, 1998.

(b) Bylaws, as amended, incorporated by reference to Exhibit 3(ii) to Grainger's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004.

(4) Instruments Defining the Rights of Security Holders, Including Indentures

(a) Agreement dated as of April 28, 1999 between Grainger and Fleet National Bank (formerly Bank Boston, NA), as rights agent, incorporated by reference to Exhibit 4 to Grainger's Current Report on Form 8-K dated April 28, 1999, and related letter concerning the appointment of EquiServe Trust Company, N.A.(now Computershare Trust Company, N.A.), as successor rights agent, effective August 1, 2002, incorporated by reference to Exhibit 4 to Grainger's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002.

(b) No instruments which define the rights of holders of Grainger's Industrial Development Revenue Bonds are filed herewith, pursuant to the exemption contained in Regulation S-K, Item 601(b)(4)(iii). Grainger hereby agrees to furnish to the Securities and Exchange Commission, upon request, a copy of any such instrument.

(10) Material Contracts:

Compensatory Plans or Arrangements

(i) Director Stock Plan, as amended, incorporated by reference to Exhibit 10(d)(i) to Grainger's Annual Report on Form 10-K for the year ended December 31, 1998.

(ii) Office of the Chairman Incentive Plan, incorporated by reference to Appendix B of Grainger's Proxy Statement dated March 26, 1997.

(iii) 1990 Long-Term Stock Incentive Plan, as amended, incorporated by reference to Exhibit 10(a) to Grainger's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004.

(iv) 2001 Long-Term Stock Incentive Plan, as amended, incorporated by reference to Exhibit 10(b) to Grainger's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004.

(v) Executive Death Benefit Plan, as amended, incorporated by reference to Exhibit 10(b)(v) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2001.

(vi) Executive Deferred Compensation Plan, incorporated by reference to Exhibit 10(e) to Grainger's Annual Report on Form 10-K for the year ended December 31, 1989.

(vii) 1985 Executive Deferred Compensation Plan, as amended, incorporated by reference to Exhibit 10(d)(vii) to Grainger's Annual Report on Form 10-K for the year ended December 31, 1998.

(viii) Supplemental Profit Sharing Plan, as amended, incorporated by reference to Exhibit 10(viii) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2003.

(ix) Supplemental Profit Sharing Plan II.

(x) Form of Change in Control Employment Agreement between Grainger and certain of its executive officers, incorporated by reference to Exhibit 10(c) to Grainger's Annual Report on Form 10-K for the year ended December 31, 1999.

(xi) Voluntary Salary and Incentive Deferral Plan, incorporated by reference to Exhibit 10(x) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2003.

(xii) Summary Description of Directors Compensation Program effective January 1, 2005, incorporated by reference to Exhibit 10(xv) to Grainger's Annual Report on Form 10-K for the year ended December 31, 2004.

(xiii) 2005 Incentive Plan, incorporated by reference to Appendix B of Grainger's Proxy Statement dated March 18, 2005.

(xiv) Form of Stock Option Award Agreement between Grainger and certain of its executive officers.

(xv) Form of Stock Option and Restricted Stock Unit Agreement between Grainger and certain of its executive officers.

(xvi) Form of Performance Share Award Agreement between Grainger and certain of its executive officers.

(xvii) Summary Description of 2006 Management Incentive Program.

(11) Computations of Earnings Per Share.

(21) Subsidiaries of Grainger.

(23) Consent of Independent Registered Public Accounting Firm.

(31) Rule 13a – 14(a)/15d – 14(a) Certifications

(a) Chief Executive Officer certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

(b) Chief Financial Officer certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

(32) Section 1350 Certifications

(a) Chief Executive Officer certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Chief Financial Officer certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

Pursuant to the requirements of Section 13 of the Securities Exchange Act of 1934, Grainger has duly issued this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DATE: February 24, 2006

W.W. GRAINGER, INC.

By: Richard L. Keyser

Richard L. Keyser
Chairman of the Board
and Chief Executive Officer

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed below by the following persons on behalf of Grainger on February 24, 2006, in the capacities indicated.

Richard L. Keyser

Richard L. Keyser
Chairman of the Board
and Chief Executive Officer
(Principal Executive Officer and Director)

Stuart L. Levenick

Stuart L. Levenick
Director

P. Ogden Loux

P. Ogden Loux
Senior Vice President, Finance
and Chief Financial Officer
(Principal Financial Officer)

John W. McCarter, Jr.

John W. McCarter, Jr.
Director

Judith E. Andringa

Judith E. Andringa
Vice President and Controller
(Principal Accounting Officer)

Neil S. Novich

Neil S. Novich
Director

Brian P. Anderson

Brian P. Anderson
Director

Gary L. Rogers

Gary L. Rogers
Director

Wilbur H. Gantz

Wilbur H. Gantz
Director

James D. Slavik

James D. Slavik
Director

David W. Grainger

David W. Grainger
Director

Harold B. Smith

Harold B. Smith
Director

William K. Hall

William K. Hall
Director