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December 31, 2007, 2006 and 2005

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## 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, 2007, 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, 2007.

Ernst & Young LLP, an independent registered public accounting firm, has audited management's effectiveness of Grainger's internal control over financial reporting as of December 31, 2007, as stated in their report which is included herein.

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited W.W. Grainger, Inc.'s internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). W.W. Grainger, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, W.W. Grainger, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of W.W. Grainger, Inc. and subsidiaries as of December 31, 2007, 2006 and 2005, and the related consolidated statements of earnings, comprehensive earnings, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2007 of W.W. Grainger, Inc., and our report dated February 25, 2008, expressed an unqualified opinion thereon.

Ernst & Young LLP

Chicago, Illinois  
February 25, 2008

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited the accompanying consolidated balance sheets of W.W. Grainger, Inc. and subsidiaries as of December 31, 2007, 2006, and 2005, and the related consolidated statements of earnings, comprehensive earnings, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of W.W. Grainger, Inc. and subsidiaries at December 31, 2007, 2006 and 2005, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

As described in Note 2 to the consolidated financial statements, effective January 1, 2007, the Company changed its method of accounting for uncertain tax positions to conform with FIN 48, "Accounting for Uncertainty in Income Taxes."

As described in Note 2 to the consolidated financial statements, effective January 1, 2006, the Company changed its method of accounting for share-based payments to conform with FASB Statement No. 123(R).

As described in Note 14 to the consolidated financial statements, effective December 31, 2006, the Company changed its method of accounting for other postretirement plans to conform with FASB Statement No. 158.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), W.W. Grainger, Inc.'s internal control over financial reporting as of December 31, 2007, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 25, 2008 expressed an unqualified opinion thereon.

Ernst & Young LLP

Chicago, Illinois  
February 25, 2008

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

### CONSOLIDATED STATEMENTS OF EARNINGS

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

	For the Years Ended December 31,		
	2007	2006	2005
Net sales .....	\$6,418,014	\$5,883,654	\$5,526,636
Cost of merchandise sold .....	3,814,391	3,529,504	3,365,095
Gross profit .....	2,603,623	2,354,150	2,161,541
Warehousing, marketing and administrative expenses .....	1,932,970	1,776,079	1,642,552
Operating earnings .....	670,653	578,071	518,989
Other income and (expense):			
Interest income .....	12,125	21,496	12,882
Interest expense .....	(2,974)	(1,926)	(1,863)
Equity in net income of unconsolidated entities .....	2,016	2,960	2,809
Gain on sale of unconsolidated entity .....	—	2,291	—
Unclassified – net .....	41	131	(143)
Total other income and (expense) .....	11,208	24,952	13,685
Earnings before income taxes .....	681,861	603,023	532,674
Income taxes .....	261,741	219,624	186,350
Net earnings .....	<u>\$ 420,120</u>	<u>\$ 383,399</u>	<u>\$ 346,324</u>
Earnings per share:			
Basic .....	<u>\$ 5.10</u>	<u>\$ 4.36</u>	<u>\$ 3.87</u>
Diluted .....	<u>\$ 4.94</u>	<u>\$ 4.24</u>	<u>\$ 3.78</u>
Weighted average number of shares outstanding:			
Basic .....	<u>82,403,958</u>	<u>87,838,723</u>	<u>89,568,746</u>
Diluted .....	<u>85,044,963</u>	<u>90,523,774</u>	<u>91,588,295</u>

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

**W.W. Grainger, Inc. and Subsidiaries**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS**

(In thousands of dollars)

	For the Years Ended December 31,		
	2007	2006	2005
Net earnings .....	\$420,120	\$383,399	\$346,324
Other comprehensive earnings (losses):			
Foreign currency translation adjustments, net of tax (expense) benefit of \$(9,279), \$147 and \$(1,642), respectively .....	53,545	(1,181)	9,383
Defined postretirement benefit plan:			
Prior service credit arising during period .....	9,433	—	—
Amortization of prior service credit.....	(437)	—	—
Amortization of transition asset.....	(143)	—	—
Net gain arising during period.....	11,620	—	—
Amortization of net loss .....	2,094	—	—
Income tax expense .....	(8,756)	—	—
	13,811	—	—
Gain (loss) on other employment-related benefit plans, net of tax (expense) benefit of \$(878), \$(21) and \$226, respectively.....	1,384	33	(353)
	68,740	(1,148)	9,030
Comprehensive earnings, net of tax.....	\$488,860	\$382,251	\$355,354

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

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**W.W. Grainger, Inc. and Subsidiaries****CONSOLIDATED BALANCE SHEETS**

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

ASSETS	As of December 31,		
	2007	2006	2005
CURRENT ASSETS			
Cash and cash equivalents .....	\$ 113,437	\$ 348,471	\$ 544,894
Marketable securities at cost, which approximates market value .....	20,074	12,827	—
Accounts receivable (less allowances for doubtful accounts of \$25,830, \$18,801 and \$18,401, respectively) .....	602,650	566,607	518,625
Inventories .....	946,327	827,254	791,212
Prepaid expenses and other assets .....	61,666	58,804	54,334
Deferred income taxes .....	56,663	48,123	76,474
Total current assets .....	1,800,817	1,862,086	1,985,539
PROPERTY, BUILDINGS AND EQUIPMENT			
Land .....	178,321	167,218	162,123
Buildings, structures and improvements .....	977,837	890,380	841,031
Furniture, fixtures, machinery and equipment .....	848,118	769,506	716,497
	2,004,276	1,827,104	1,719,651
Less accumulated depreciation and amortization .....	1,125,931	1,034,169	949,026
Property, buildings and equipment – net .....	878,345	792,935	770,625
DEFERRED INCOME TAXES .....	54,658	48,793	16,702
INVESTMENTS IN UNCONSOLIDATED ENTITIES .....	14,759	8,492	25,155
GOODWILL .....	233,028	210,671	182,726
OTHER ASSETS AND INTANGIBLES – NET .....	112,421	123,111	127,174
TOTAL ASSETS .....	<u>\$3,094,028</u>	<u>\$3,046,088</u>	<u>\$3,107,921</u>

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

### CONSOLIDATED BALANCE SHEETS – CONTINUED

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

LIABILITIES AND SHAREHOLDERS' EQUITY	As of December 31,		
	2007	2006	2005
<b>CURRENT LIABILITIES</b>			
Short-term debt.....	\$ 102,060	\$ —	\$ —
Current maturities of long-term debt.....	4,590	4,590	4,590
Trade accounts payable.....	297,929	334,820	319,254
Accrued compensation and benefits.....	182,275	140,141	152,543
Accrued contributions to employees' profit sharing plans.....	126,483	113,014	90,478
Accrued expenses.....	102,607	106,681	103,932
Income taxes.....	10,459	7,077	24,554
Total current liabilities.....	826,403	706,323	695,351
LONG-TERM DEBT (less current maturities).....	4,895	4,895	4,895
DEFERRED INCOME TAXES AND TAX UNCERTAINTIES.....	20,727	6,235	7,019
ACCRUED EMPLOYMENT-RELATED BENEFITS COSTS.....	143,895	151,020	111,680
<b>SHAREHOLDERS' EQUITY</b>			
Cumulative Preferred Stock – \$5 par value – 12,000,000 shares authorized; none issued nor outstanding.....	—	—	—
Common Stock – \$0.50 par value – 300,000,000 shares authorized; issued, 109,659,219, 109,657,938 and 109,667,938 shares, respectively.....	54,830	54,829	54,834
Additional contributed capital.....	475,350	478,454	451,578
Retained earnings.....	3,316,875	3,007,606	2,722,103
Unearned restricted stock compensation.....	—	—	(17,280)
Accumulated other comprehensive earnings.....	72,171	3,431	27,082
Treasury stock, at cost – 30,199,804, 25,590,311 and 19,952,297 shares, respectively.....	(1,821,118)	(1,366,705)	(949,341)
Total shareholders' equity.....	2,098,108	2,177,615	2,288,976
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY.....</b>	<b>\$3,094,028</b>	<b>\$3,046,088</b>	<b>\$3,107,921</b>

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

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

### CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands of dollars)

	For the Years Ended December 31,		
	2007	2006	2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net earnings .....	\$ 420,120	\$ 383,399	\$ 346,324
Provision for losses on accounts receivable .....	15,436	6,057	1,326
Deferred income taxes and tax uncertainties.....	(18,632)	9,858	23,663
Depreciation and amortization:			
Property, buildings and equipment .....	106,839	100,975	98,087
Capitalized software and other intangibles .....	25,160	17,593	10,695
Stock-based compensation.....	35,551	33,741	9,015
Tax benefit of stock incentive plans.....	3,193	1,563	11,962
Net gains on sales of property,			
buildings and equipment.....	(7,254)	(11,035)	(7,337)
Income from unconsolidated entities.....	(2,016)	(2,960)	(2,809)
Gain on sale of unconsolidated entity .....	—	(2,291)	—
Change in operating assets and liabilities –			
net of business acquisitions:			
(Increase) decrease in accounts receivable .....	(41,814)	(53,056)	(36,378)
(Increase) decrease in inventories .....	(97,234)	(33,839)	(84,031)
(Increase) decrease in prepaid expenses .....	(2,342)	(3,918)	(6,251)
Increase (decrease) in trade accounts payable .....	(39,436)	10,888	27,121
Increase (decrease) in other current liabilities .....	54,457	(2,558)	43,056
Increase (decrease) in current income			
taxes payable .....	2,304	(17,395)	(10,632)
Increase (decrease) in accrued			
employment-related benefits costs .....	17,705	2,634	10,012
Other – net .....	(3,162)	(2,903)	(1,280)
Net cash provided by operating activities.....	468,875	436,753	432,543
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Additions to property, buildings and equipment .....	(188,867)	(127,814)	(112,297)
Proceeds from sales of property,			
buildings and equipment – net .....	12,084	17,314	15,037
Additions to capitalized software.....	(8,556)	(8,950)	(44,950)
Proceeds from sale of marketable securities .....	12,765	—	—
Purchase of marketable securities .....	(17,079)	(13,187)	—
Proceeds from sale of unconsolidated entity .....	—	27,843	—
Net cash paid for business acquisitions.....	(4,698)	(34,390)	(24,817)
(Investments in) and loan repayment			
from unconsolidated entities.....	(2,138)	(3,988)	4,088
Other – net .....	(468)	3,426	(46)
Net cash used in investing activities .....	(196,957)	(139,746)	(162,985)

**W.W. Grainger, Inc. and Subsidiaries**

**CONSOLIDATED STATEMENTS OF CASH FLOWS – CONTINUED**

(In thousands of dollars)

	For the Years Ended December 31,		
	<u>2007</u>	<u>2006</u>	<u>2005</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net increase in commercial paper .....	\$ 95,947	\$ —	\$ —
Borrowings under line of credit.....	14,107	—	—
Payments against line of credit.....	(7,751)	—	—
Stock options exercised .....	113,500	64,437	65,997
Excess tax benefits from stock-based compensation.....	30,696	13,373	—
Purchase of treasury stock .....	(647,293)	(472,787)	(137,473)
Cash dividends paid.....	(113,093)	(97,896)	(82,663)
Net cash used in financing activities .....	(513,887)	(492,873)	(154,139)
Exchange rate effect on cash and cash equivalents .....	6,935	(557)	229
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS .....	(235,034)	(196,423)	115,648
Cash and cash equivalents at beginning of year .....	348,471	544,894	429,246
Cash and cash equivalents at end of year .....	<u>\$ 113,437</u>	<u>\$ 348,471</u>	<u>\$ 544,894</u>
Supplemental cash flow information:			
Cash payments for interest (net of amounts capitalized) .....	\$ 4,409	\$ 1,413	\$ 1,791
Cash payments for income taxes .....	244,541	212,350	162,030
Noncash investing activities:			
Fair value of noncash assets acquired in business acquisitions .....	\$ 5,039	\$ 38,430	\$ 26,811
Liabilities assumed in business acquisitions.....	(341)	(4,040)	(1,994)

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

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

### CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

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

	Common Stock	Additional Contributed Capital	Retained Earnings	Unearned Restricted Stock Compensation	Accumulated Other Comprehensive Earnings (Losses)	Treasury Stock
Balance at January 1, 2005.....	\$54,836	\$432,171	\$2,458,442	\$(14,463)	\$ 18,052	\$ (881,068)
Exercise of stock options .....	—	(3,882)	—	—	—	69,879
Tax benefits on stock-based compensation awards .....	—	11,962	—	—	—	—
Issuance of other stock-based compensation awards .....	—	12,932	—	(12,932)	—	—
Remeasurement of stock options and other stock-based compensation awards .....	—	303	—	(208)	—	—
Cancellation of other stock-based compensation awards .....	(2)	(1,401)	—	1,403	—	—
Amortization of unearned compensation on other stock-based compensation awards ...	—	—	—	8,920	—	—
Vesting of restricted stock .....	—	—	—	—	—	(994)
Settlement of other stock-based compensation awards .....	—	(507)	—	—	—	315
Purchase of 2,372,300 shares of treasury stock .....	—	—	—	—	—	(137,473)
Other comprehensive earnings.....	—	—	—	—	9,030	—
Net earnings .....	—	—	346,324	—	—	—
Cash dividends paid (\$0.920 per share) .....	—	—	(82,663)	—	—	—
Balance at December 31, 2005 .....	\$54,834	\$451,578	\$2,722,103	\$(17,280)	\$ 27,082	\$ (949,341)
Exercise of stock options .....	—	(3,984)	—	—	—	68,421
Tax benefits on stock-based compensation awards .....	—	14,936	—	—	—	—
Stock option expense.....	—	19,904	—	—	—	—
Cancellation of other stock-based compensation awards .....	(5)	5	—	—	—	—
Amortization of unearned compensation on other stock-based compensation awards ...	—	13,845	—	—	—	—
Vesting of restricted stock .....	—	—	—	—	—	(4,263)
Settlement of other stock-based compensation awards .....	—	(1,003)	—	—	—	592
Purchase of 6,983,000 shares of treasury stock .....	—	—	—	—	—	(482,114)
Other comprehensive earnings.....	—	—	—	—	(1,148)	—
Adjustment to initially apply SFAS No. 158 to postretirement benefit plans, net of tax benefit of \$14,280 .....	—	—	—	—	(22,503)	—
Reclassification of unearned restricted stock compensation .....	—	(17,280)	—	17,280	—	—
Change in interest – joint venture .....	—	453	—	—	—	—
Net earnings .....	—	—	383,399	—	—	—
Cash dividends paid (\$1.110 per share) .....	—	—	(97,896)	—	—	—
Balance at December 31, 2006 .....	\$54,829	\$478,454	\$3,007,606	\$ —	\$ 3,431	\$(1,366,705)

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

**W.W. Grainger, Inc. and Subsidiaries**

**CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY – CONTINUED**

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

	Common Stock	Additional Contributed Capital	Retained Earnings	Unearned Restricted Stock Compensation	Accumulated Other Comprehensive Earnings (Losses)	Treasury Stock
Balance at December 31, 2006 .....	\$54,829	\$478,454	\$3,007,606	\$ —	\$ 3,431	\$(1,366,705)
Adoption of FIN 48 .....	—	—	870	—	—	—
Reinstatement of equity method.....	—	—	1,372	—	—	—
Exercise of stock options .....	—	(19,991)	—	—	—	133,491
Tax benefits on stock-based compensation awards .....	—	33,889	—	—	—	—
Stock option expense.....	—	16,888	—	—	—	—
Amortization of unearned compensation on other stock-based compensation awards ...	—	18,667	—	—	—	—
Vesting of restricted stock .....	—	—	—	—	—	(1,126)
Settlement of other stock-based compensation awards .....	1	(2,557)	—	—	—	1,189
Purchase of 7,051,607 shares of treasury stock .....	—	(50,000)	—	—	—	(587,967)
Other comprehensive earnings.....	—	—	—	—	68,740	—
Net earnings .....	—	—	420,120	—	—	—
Cash dividends paid (\$1.340 per share) .....	—	—	(113,093)	—	—	—
Balance at December 31, 2007 .....	<u>\$54,830</u>	<u>\$475,350</u>	<u>\$3,316,875</u>	<u>\$ —</u>	<u>\$ 72,171</u>	<u>\$(1,821,118)</u>

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