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December 31, 2008, 2007 and 2006

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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, 2008, 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, 2008.

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, 2008, as stated in their report which is included herein.

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, 2008, 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, 2008, 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, 2008, 2007 and 2006, 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, 2008 of W.W. Grainger, Inc., and our report dated February 25, 2009, expressed an unqualified opinion thereon.

Ernst & Young LLP

Chicago, Illinois
February 25, 2009

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, 2008, 2007, and 2006, 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, 2008. 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, 2008, 2007 and 2006, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles.

As described in Note 15 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 12 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, 2008, 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, 2009 expressed an unqualified opinion thereon.

Ernst & Young LLP

Chicago, Illinois
February 25, 2009

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,		
	2008	2007	2006
Net sales	\$6,850,032	\$6,418,014	\$5,883,654
Cost of merchandise sold	4,041,810	3,814,391	3,529,504
Gross profit	2,808,222	2,603,623	2,354,150
Warehousing, marketing and administrative expenses	2,025,550	1,932,970	1,776,079
Operating earnings	782,672	670,653	578,071
Other income and (expense):			
Interest income	5,069	12,125	21,496
Interest expense	(14,485)	(2,974)	(1,926)
Equity in net income of unconsolidated entities	3,642	2,016	2,960
Write-off of investment in unconsolidated entity	(6,031)	—	—
Gain on sale of unconsolidated entity	—	—	2,291
Unclassified – net	2,351	41	131
Total other income and (expense)	(9,454)	11,208	24,952
Earnings before income taxes	773,218	681,861	603,023
Income taxes	297,863	261,741	219,624
Net earnings	<u>\$ 475,355</u>	<u>\$ 420,120</u>	<u>\$ 383,399</u>
Earnings per share:			
Basic	<u>\$ 6.21</u>	<u>\$ 5.10</u>	<u>\$ 4.36</u>
Diluted	<u>\$ 6.04</u>	<u>\$ 4.94</u>	<u>\$ 4.24</u>
Weighted average number of shares outstanding:			
Basic	<u>76,579,856</u>	<u>82,403,958</u>	<u>87,838,723</u>
Diluted	<u>78,750,328</u>	<u>85,044,963</u>	<u>90,523,774</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,		
	2008	2007	2006
Net earnings	\$475,355	\$420,120	\$383,399
Other comprehensive earnings (losses):			
Foreign currency translation adjustments, net of tax benefit (expense) of \$11,454, \$(9,279) and \$147, respectively	(79,287)	53,545	(1,181)
Defined postretirement benefit plan:			
Prior service credit arising during period	—	9,433	—
Amortization of prior service credit.....	(1,215)	(437)	—
Amortization of transition asset.....	(143)	(143)	—
Net gain (loss) arising during period	(49,872)	11,620	—
Amortization of net loss	1,312	2,094	—
Income tax benefit (expense)	19,368	(8,756)	—
	(30,550)	13,811	—
Gain (loss) on other employment-related benefit plans, net of tax benefit (expense) of \$544, \$(878) and \$(21), respectively	(859)	1,384	33
	(110,696)	68,740	(1,148)
Comprehensive earnings, net of tax.....	\$364,659	\$488,860	\$382,251

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

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

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

ASSETS	As of December 31,		
	2008	2007	2006
CURRENT ASSETS			
Cash and cash equivalents	\$ 396,290	\$ 113,437	\$ 348,471
Marketable securities at cost, which approximates market value	—	20,074	12,827
Accounts receivable (less allowances for doubtful accounts of \$26,481, \$25,830 and \$18,801, respectively)	589,416	602,650	566,607
Inventories	1,009,932	946,327	827,254
Prepaid expenses and other assets	73,359	61,666	58,804
Deferred income taxes	52,556	56,663	48,123
Prepaid income taxes	22,556	—	—
Total current assets	2,144,109	1,800,817	1,862,086
PROPERTY, BUILDINGS AND EQUIPMENT			
Land	192,916	178,321	167,218
Buildings, structures and improvements	1,048,440	977,837	890,380
Furniture, fixtures, machinery and equipment	890,507	848,118	769,506
	2,131,863	2,004,276	1,827,104
Less accumulated depreciation and amortization	1,201,552	1,125,931	1,034,169
Property, buildings and equipment – net	930,311	878,345	792,935
DEFERRED INCOME TAXES	97,442	54,658	48,793
INVESTMENTS IN UNCONSOLIDATED ENTITIES	20,830	14,759	8,492
GOODWILL	213,159	233,028	210,671
OTHER ASSETS AND INTANGIBLES – NET	109,566	112,421	123,111
TOTAL ASSETS	<u>\$3,515,417</u>	<u>\$3,094,028</u>	<u>\$3,046,088</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,		
	2008	2007	2006
CURRENT LIABILITIES			
Short-term debt.....	\$ 19,960	\$ 102,060	\$ —
Current maturities of long-term debt.....	21,257	4,590	4,590
Trade accounts payable	290,802	297,929	334,820
Accrued compensation and benefits	162,380	182,275	140,141
Accrued contributions to employees' profit sharing plans	146,922	126,483	113,014
Accrued expenses.....	118,633	102,607	106,681
Income taxes payable	1,780	10,459	7,077
Total current liabilities	761,734	826,403	706,323
LONG-TERM DEBT (less current maturities).....	488,228	4,895	4,895
DEFERRED INCOME TAXES AND TAX UNCERTAINTIES.....	33,219	20,727	6,235
ACCRUED EMPLOYMENT-RELATED BENEFITS COSTS.....	198,431	143,895	151,020
SHAREHOLDERS' EQUITY			
Cumulative Preferred Stock – \$5 par value – 12,000,000 shares authorized; none issued nor outstanding	—	—	—
Common Stock – \$0.50 par value – 300,000,000 shares authorized; issued, 109,659,219, 109,659,219 and 109,657,938 shares, respectively	54,830	54,830	54,829
Additional contributed capital.....	564,728	475,350	478,454
Retained earnings	3,670,726	3,316,875	3,007,606
Accumulated other comprehensive earnings.....	(38,525)	72,171	3,431
Treasury stock, at cost – 34,878,190, 30,199,804 and 25,590,311 shares, respectively	(2,217,954)	(1,821,118)	(1,366,705)
Total shareholders' equity	2,033,805	2,098,108	2,177,615
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$3,515,417	\$3,094,028	\$3,046,088

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,		
	2008	2007	2006
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net earnings	\$ 475,355	\$ 420,120	\$ 383,399
Provision for losses on accounts receivable	12,924	15,436	6,057
Deferred income taxes and tax uncertainties.....	5,182	(18,632)	9,858
Depreciation and amortization:			
Property, buildings and equipment	112,443	106,839	100,975
Capitalized software and other intangibles	27,127	25,160	17,593
Stock-based compensation.....	45,945	35,551	33,741
Tax benefit of stock incentive plans.....	1,925	3,193	1,563
Net gains on sales of property,			
buildings and equipment.....	(9,232)	(7,254)	(11,035)
Income from unconsolidated entities.....	(3,642)	(2,016)	(2,960)
Gain on sale of unconsolidated entity	—	—	(2,291)
Write-off of unconsolidated entity	6,031	—	—
Change in operating assets and liabilities –			
net of business acquisitions:			
(Increase) in accounts receivable	(5,592)	(41,814)	(53,056)
(Increase) in inventories	(92,518)	(97,234)	(33,839)
(Increase) in prepaid income taxes	(22,556)	—	—
(Increase) in prepaid expenses.....	(11,073)	(2,342)	(3,918)
Increase (decrease) in trade accounts payable	(6,960)	(39,436)	10,888
Increase (decrease) in other current liabilities	199	54,457	(2,558)
Increase (decrease) in current income			
taxes payable	(7,784)	2,304	(17,395)
Increase in accrued employment-related			
benefits costs	3,216	17,705	2,634
Other – net	(924)	(3,162)	(2,903)
Net cash provided by operating activities.....	530,066	468,875	436,753
CASH FLOWS FROM INVESTING ACTIVITIES:			
Additions to property, buildings and equipment	(182,678)	(188,867)	(127,814)
Proceeds from sales of property, buildings and			
equipment	13,620	12,084	17,314
Additions to capitalized software.....	(12,297)	(8,556)	(8,950)
Proceeds from sale of marketable securities	19,848	12,765	—
Purchase of marketable securities	—	(17,079)	(13,187)
Proceeds from sale of unconsolidated entity	—	—	27,843
Net cash paid for business acquisitions.....	(34,290)	(4,698)	(34,390)
Investments in unconsolidated entities.....	(6,487)	(2,138)	(3,988)
Other – net	(351)	(468)	3,426
Net cash used in investing activities	(202,635)	(196,957)	(139,746)

W.W. Grainger, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF CASH FLOWS – CONTINUED

(In thousands of dollars)

	For the Years Ended December 31,		
	2008	2007	2006
CASH FLOWS FROM FINANCING ACTIVITIES:			
Net increase (decrease) in commercial paper	\$ (95,947)	\$ 95,947	\$ —
Borrowings under line of credit	29,959	14,107	—
Payments against line of credit	(15,437)	(7,751)	—
Proceeds from issuance of long-term debt	500,000	—	—
Proceeds from stock options exercised	46,833	113,500	64,437
Excess tax benefits from stock-based compensation	13,533	30,696	13,373
Purchase of treasury stock	(394,247)	(647,293)	(472,787)
Cash dividends paid	(121,504)	(113,093)	(97,896)
	(36,810)	(513,887)	(492,873)
Exchange rate effect on cash and cash equivalents	(7,768)	6,935	(557)
	282,853	(235,034)	(196,423)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS			
Cash and cash equivalents at beginning of year	113,437	348,471	544,894
Cash and cash equivalents at end of year	\$ 396,290	\$ 113,437	\$ 348,471
Supplemental cash flow information:			
Cash payments for interest (net of amounts capitalized)	\$ 14,508	\$ 4,409	\$ 1,413
Cash payments for income taxes	306,960	244,541	212,350
Noncash investing activities:			
Fair value of noncash assets acquired in business acquisitions	\$ 41,068	\$ 5,039	\$ 38,430
Liabilities assumed in business acquisitions	(6,778)	(341)	(4,040)

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, 2006.....	\$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 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 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 (\$1.11 per share).....	—	—	(97,896)	—	—	—
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 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 treasury stock.....	—	(50,000)	—	—	—	(587,967)
Other comprehensive earnings.....	—	—	—	—	68,740	—
Net earnings.....	—	—	420,120	—	—	—
Cash dividends paid (\$1.34 per share).....	—	—	(113,093)	—	—	—
Balance at December 31, 2007	\$54,830	\$475,350	\$3,316,875	\$ —	\$ 72,171	\$(1,821,118)

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, 2007	\$54,830	\$475,350	\$3,316,875	\$ —	\$ 72,171	\$(1,821,118)
Exercise of stock options	—	(12,663)	—	—	—	59,460
Tax benefits on stock-based compensation awards	—	15,458	—	—	—	—
Stock option expense.....	—	19,868	—	—	—	—
Amortization of other stock-based compensation awards	—	26,077	—	—	—	—
Vesting of restricted stock	—	—	—	—	—	(417)
Settlement of other stock-based compensation awards	—	(9,362)	—	—	—	5,209
Purchase of treasury stock.....	—	50,000	—	—	—	(461,088)
Other comprehensive earnings.....	—	—	—	—	(110,696)	—
Net earnings	—	—	475,355	—	—	—
Cash dividends paid (\$1.55 per share)	—	—	(121,504)	—	—	—
Balance at December 31, 2008	<u>\$54,830</u>	<u>\$564,728</u>	<u>\$3,670,726</u>	<u>\$ —</u>	<u>\$ (38,525)</u>	<u>\$(2,217,954)</u>

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