
W.W. Grainger, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008, 2007 and 2006

NOTE 1 – BACKGROUND AND BASIS OF PRESENTATION

INDUSTRY INFORMATION

W.W. Grainger, Inc. is the leading broad-line supplier of facilities maintenance and other related products in North America, with operations primarily in the United States, Canada and Mexico. In this report, the words “Company” or “Grainger” mean W.W. Grainger, Inc. and its subsidiaries.

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany transactions are eliminated from the consolidated financial statements.

INVESTMENTS IN UNCONSOLIDATED ENTITIES

For investments in which the Company owns or controls from 20% to 50% of the voting shares, the equity method of accounting is used. Changes in interest arising from the issuance of stock by an investee is accounted for as additional contributed capital. See Note 6 to the Consolidated Financial Statements.

MANAGEMENT ESTIMATES

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent liabilities, and revenues and expenses. Actual results could differ from those estimates.

FOREIGN CURRENCY TRANSLATION

The financial statements of the Company's foreign subsidiaries are measured using the local currency as the functional currency. Net exchange gains or losses resulting from the translation of financial statements of foreign operations and related long-term debt are recorded as a separate component of other comprehensive earnings. See Notes 2 and 14 to the Consolidated Financial Statements.

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

REVENUE RECOGNITION

Revenues recognized include product sales, billings for freight and handling charges and fees earned for services provided. The Company recognizes product sales and billings for freight and handling charges primarily on the date products are shipped to, or picked up by, the customer. The Company's standard shipping terms are FOB shipping point. On occasion, the Company will negotiate FOB destination terms. These sales are recognized upon delivery to the customer. Fee revenues, which account for less than 1% of total revenues, are recognized after services are completed.

COST OF MERCHANDISE SOLD

Cost of merchandise sold includes product and product-related costs, vendor consideration, freight-out costs and handling costs. The Company defines handling costs as those costs incurred to fulfill a shipped sales order.

VENDOR CONSIDERATION

The Company receives rebates from its vendors to promote their products. The Company utilizes numerous advertising programs to promote its vendors' products, including catalogs and other printed media, Internet and other marketing programs. Most of these programs relate to multiple vendors, which makes supporting the specific, identifiable and incremental criteria difficult, and would require numerous assumptions and judgments. Based on the inexact nature of trying to track reimbursements to the exact advertising expenditure for each vendor, the Company treats most vendor advertising allowances as a reduction of cost of merchandise sold rather than a reduction of operating (advertising) expenses. Rebates earned from vendors that are based on product purchases are capitalized into inventory as part of product purchase price. These rebates are credited to cost of merchandise sold based on sales. Vendor rebates that are earned based on products sold are credited directly to cost of merchandise sold.

ADVERTISING

Advertising costs are expensed in the year the related advertisement is first presented. Advertising expense was \$120.7 million, \$122.4 million and \$115.4 million for 2008, 2007 and 2006, respectively. Most vendor-provided allowances are classified as an offset to cost of merchandise sold. For additional information see VENDOR CONSIDERATION above.

For interim reporting purposes, advertising expense is amortized equally over each period, based on estimated expenses for the full year. Advertising costs for media that have not been distributed by year-end are capitalized as Prepaid expenses. Amounts included in Prepaid expenses at December 31, 2008, 2007 and 2006 were \$39.5 million, \$32.1 million and \$30.2 million, respectively.

WAREHOUSING, MARKETING AND ADMINISTRATIVE EXPENSES

Included in this category are purchasing, branch operations, information services, and marketing and selling expenses, as well as other types of general and administrative costs.

STOCK INCENTIVE PLANS

The Company measures all share-based payments using fair-value-based methods and records compensation expense related to these payments in the consolidated financial statements. The Company values stock option compensation using a binomial lattice option-pricing model. See Note 12 to the Consolidated Financial Statements.

INCOME TAXES

Income taxes are recognized during the year in which transactions enter into the determination of financial statement income, with deferred taxes being provided for temporary differences between financial and tax reporting.

OTHER COMPREHENSIVE EARNINGS (LOSSES)

The Company's Other comprehensive earnings (losses) include foreign currency translation adjustments and unrecognized gains (losses) on postretirement and other employment-related benefit plans. See Note 14 to the Consolidated Financial Statements.

CASH AND MARKETABLE SECURITIES

The Company considers investments in highly liquid debt instruments, purchased with an original maturity of ninety days or less, to be cash equivalents. For cash equivalents, the carrying amount approximates fair value due to the short maturity of these instruments.

The Company's investments in marketable securities consist of commercial paper to be held to maturity. These investments have an original maturity date of more than 90 days. The investments are issued from high credit quality issuers. The marketable securities are recorded at cost, which approximates fair value.

CONCENTRATION OF CREDIT RISK

The Company places temporary cash investments with institutions of high credit quality and, by policy, limits the amount of credit exposure to any one institution.

The Company has a broad customer base representing many diverse industries doing business in all regions of the United States, Canada, Mexico, Panama, and China. Consequently, no significant concentration of credit risk is considered to exist.

ALLOWANCE FOR DOUBTFUL ACCOUNTS

The Company establishes reserves for customer accounts that are potentially uncollectible. The method used to estimate the allowances is based on several factors, including the age of the receivables and the historical ratio of actual write-offs to the age of the receivables. These analyses also take into consideration economic conditions that may have an impact on a specific industry, group of customers or a specific customer.

INVENTORIES

Inventories are valued at the lower of cost or market. Cost is determined primarily by the last-in, first-out (LIFO) method, which accounts for approximately 77% of total inventory. For the remaining inventory, cost is determined by the first-in, first-out (FIFO) method.

PROPERTY, BUILDINGS AND EQUIPMENT

Property, buildings and equipment are valued at cost. For financial statement purposes, depreciation and amortization are provided in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives, principally on the declining-balance and sum-of-the-years-digits methods. The principal estimated useful lives for determining depreciation are as follows:

Buildings, structures and improvements	10 to 45 years
Furniture, fixtures, machinery and equipment.....	3 to 10 years

Improvements to leased property are amortized over the initial terms of the respective leases or the estimated service lives of the improvements, whichever is shorter.

The Company capitalized interest costs of \$1.3 million, \$1.4 million and \$0.3 million in 2008, 2007 and 2006, respectively.

LONG-LIVED ASSETS

The carrying value of long-lived assets is evaluated whenever events or changes in circumstances indicate that the carrying value of the asset may be impaired. An impairment loss is recognized when estimated undiscounted future cash flows resulting from use of the asset, including disposition, is less than the carrying value of the asset. Impairment is measured as the amount by which the carrying amount exceeds the fair value.

GOODWILL AND OTHER INTANGIBLES

Goodwill is recognized as the excess cost of an acquired entity over the net amount assigned to assets acquired and liabilities assumed. Goodwill is not amortized, but rather tested for impairment on an annual basis and more often if circumstances require. Impairment losses are recognized whenever the implied fair value of goodwill is less than its carrying value.

The Company recognizes an acquired intangible apart from goodwill whenever the intangible arises from contractual or other legal rights, or whenever it can be separated or divided from the acquired entity and sold, transferred, licensed, rented or exchanged, either individually or in combination with a related contract, asset or liability. Such intangibles are amortized over their estimated useful lives unless the estimated useful life is determined to be indefinite. Amortizable intangible assets are being amortized over useful lives of three to 17 years. Impairment losses are recognized if the carrying amount of an intangible, subject to amortization, is not recoverable from expected future cash flows and its carrying amount exceeds its fair value.

The Company also maintains intangible assets with indefinite lives, which are not amortized. These intangibles are tested for impairment on an annual basis and more often if circumstances require, similar to the treatment for goodwill. Impairment losses are recognized whenever the implied fair value of these assets is less than their carrying value.

INSURANCE RESERVES

The Company purchases insurance for catastrophic exposures and those risks required to be insured by law. It also retains a significant portion of the risk of certain losses related to workers' compensation, general liability and property losses through the utilization of high deductibles and self-insured retentions. Reserves for these potential losses are based on an external analysis of the Company's historical claims results and other actuarial assumptions.

WARRANTY RESERVES

The Company generally warrants the products it sells against defects for one year. For a significant portion of warranty claims, the manufacturer of the product is responsible for expenses. For warranty expenses not covered by the manufacturer, the Company provides a reserve for future costs based primarily on historical experience. The reserve activity was as follows (in thousands of dollars):

	As of December 31,		
	2008	2007	2006
Beginning balance	\$ 3,442	\$ 4,651	\$ 3,763
Returns	(12,917)	(12,781)	(9,579)
Provisions	12,693	11,572	10,467
Ending balance	<u>\$ 3,218</u>	<u>\$ 3,442</u>	<u>\$ 4,651</u>

NEW ACCOUNTING STANDARDS

In December 2007, the Financial Accounting Standards Board (FASB) issued SFAS No. 141 (revised 2007), "Business Combinations" (SFAS No. 141R). SFAS No. 141R establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS No. 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. The statement is effective for fiscal years beginning after December 15, 2008, and will be applied to acquisitions after adoption by the Company.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements – an amendment of Accounting Research Bulletin No. 51" (SFAS No. 160). SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS No. 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. The statement is effective for fiscal years beginning after December 15, 2008. The Company currently does not have any noncontrolling interest in consolidated financial statements, therefore does not expect the adoption of SFAS No. 160 to have a material effect on its results of operations or financial position.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, "Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133" (SFAS No. 161). SFAS No. 161 amends and expands the disclosure requirements related to derivative instruments and hedging activities which will enable investors to better understand the effects on an entity's financial statements, financial position and cash flows. The statement is effective for fiscal years beginning after November 15, 2008. The Company does not expect the adoption of SFAS No. 161 to have a material effect on its results of operations or financial position.

In April 2008, the FASB issued Staff Position FSP 142-3, "Determination of the Useful Life of Intangible Assets" (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, "Goodwill and Other Intangible Assets." FSP 142-3 is effective for fiscal years beginning after December 15, 2008. The Company does not expect the adoption of FSP 142-3 to have a material effect on its results of operations or financial position.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162, "The Hierarchy of Generally Accepted Accounting Principles" (SFAS No. 162). SFAS No. 162 is intended to improve financial reporting by

identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements that are presented in conformity with GAAP. The FASB believes that the GAAP hierarchy should be directed to entities because it is the entity (not its auditor) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. The Company does not expect the adoption of SFAS No. 162 to have a material effect on its results of operations or financial position.

In June 2008, the FASB issued Staff Position EITF 03-6-1, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities" (FSP 03-6-1). FSP 03-6-1 states that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. Upon adoption, a company is required to retrospectively adjust its earnings per share data presentation to conform with the FSP 03-6-1 provisions. FSP 03-6-1 is effective for fiscal years beginning after December 15, 2008.

The Company's unvested share-based payment awards, such as Performance Shares, Restricted Stock and Restricted Stock Units (see Note 12 to the Consolidated Financial Statements) that contain nonforfeitable rights to dividends meet the criteria of a participating security as defined by FSP 03-6-1. Accordingly, the adoption of FSP 03-6-1 will change the methodology of computing the Company's earnings per share to the two-class method. This change will not affect previously reported consolidated net earnings or net cash flows from operations. Under the two-class method, earnings will be allocated between common stock and participating securities, resulting in lower earnings per share. Refer to the table below for further analysis of the impact adoption would have had on 2008 earnings per share.

	2008 Quarter Ended				
	Mar. 31	June 30	Sept. 30	Dec. 31	Total
Earnings Per Share as previously reported					
Basic	\$1.47	\$1.48	\$1.84	\$1.42	\$6.21
Diluted.....	\$1.43	\$1.43	\$1.79	\$1.39	\$6.04
Earnings Per Share Two-class method					
Basic	\$1.44	\$1.44	\$1.80	\$1.39	\$6.07
Diluted.....	\$1.41	\$1.42	\$1.77	\$1.37	\$5.97

In November 2008, the Emerging Issues Task Force (EITF) reached a consensus on EITF Issue No. 08-7, "Accounting for Defensive Intangible Assets" (Issue 08-7). The FASB Statement No. 141(R), "Business Combinations," and FASB Statement No. 157, "Fair Value Measurements," require that assets acquired in a business combination be measured at fair value using market participant (not entity specific) assumptions. The measurement requirement includes intangible assets that the acquirer does not intend to use in the same manner as a market participant, such as those it intends to hold for defensive purposes (intangible assets that the acquirer does not intend to actively use). Defensive intangible assets generally were allocated little or no value in business combinations or asset acquisitions completed prior to the effective date of Statement No. 157. Issue 08-7 concluded that intangible assets that an acquirer intends to use as defensive assets are a separate unit of account from existing intangible assets of the acquirer. Also, Issue 08-7 concluded that a defensive intangible asset should be amortized over the period that the defensive intangible asset directly or indirectly contributes to the future cash flows of the entity. Issue 08-7 is effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early application is not permitted. The Company does not expect the adoption of EITF 08-7 to have a material effect on its results of operations or financial position.

In November 2008, the EITF reached a consensus with respect to EITF Issue No. 08-6, "Accounting for Equity Method Investments" (Issue 08-6). Under Issue 08-6, the initial carrying value of an equity method investment should be based on the cost accumulation model. The equity method investment as a whole should be assessed for other-than-temporary impairment in accordance with APB 18, "The Equity Method of Accounting for Investments in Common Stock." However, the individual indefinite-lived intangible assets underlying the equity method investment should not be individually assessed for impairment at the investor level. An equity method investor should account for an investee's issuance of shares as if the investor sold a portion of its investment with any resulting gain or loss reflected in the income statement. No changes were made to how an equity method investor should account for a change from the equity method to the cost method. Issue 08-6 is effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early application is not permitted. The Company does not expect adoption of Issue 08-6 to have a material effect on its results of operations or financial position.

In December 2008, the FASB issued FSP FAS 132(R)-1, "Employer's Disclosures about Postretirement Benefit Plan Assets." This FSP amends FASB Statement No. 132 (Revised 2003), "Employers' Disclosures about Pensions and Other Postretirement Benefits," to provide guidance on an employer's disclosures about plan assets of a defined benefit pension or other postretirement plan. The disclosures about plan assets required by this FSP shall be provided for fiscal years ending after December 15, 2009. Earlier application of the provisions of this FSP is permitted. The Company does not expect adoption of FSP FAS 132(R)-1 to have a material effect on its results of operations or financial position.

NOTE 3 – BUSINESS ACQUISITIONS

On July 21, 2008, the Company acquired a 49.9% interest in Asia Pacific Brands India Ltd. (Asia Pacific Brands) from its sole shareholder. Asia Pacific Brands, one of India's largest industrial and electrical wholesale distributors, is headquartered in Mumbai, India. With 27 locations and more than 6,200 dealer relationships across India, Asia Pacific Brands had revenue of US\$47 million for its fiscal year ended March 31, 2008. The Company paid \$5.4 million for its ownership interest. In addition, the Company and its joint venture partner each made a \$1.1 million capital infusion that was intended to help grow the business. In the fourth quarter of 2008, the Company wrote-off its investment in this joint venture due to the economic slowdown in India and the loss of a major supplier which accounted for approximately 25% of the joint venture's annual revenue. These conditions severely affect Asia Pacific Brand's ability to secure additional financing to meet its current obligations and continue as a going concern. Until the investment was written-off, the Company used the equity method to account for this investment. See Note 6 to the Consolidated Financial Statements.

On July 10, 2008, Lab Safety Supply, Inc. (Lab Safety), the direct marketing subsidiary of the Company, acquired substantially all of the assets and assumed certain liabilities of Highsmith Inc. (Highsmith). Highsmith is a direct marketing leader in the library equipment, furniture and supplies market and had sales of \$64 million in 2007. The purchase price and costs of the acquisition were \$27.5 million in cash and \$6.1 million in assumed liabilities. The estimated goodwill recognized in the transaction amounted to \$2.4 million and is deductible for tax purposes. The integration of Highsmith into operations was completed in 2008. As part of the integration, Lab Safety discontinued the contract sales group of Highsmith, which represented approximately \$19 million of sales in 2007.

On June 6, 2008, Acklands – Grainger Inc. acquired substantially all of the assets and assumed certain liabilities of Excel F.I.G. Inc. (Excel). Excel is a business-to-business broad-line distributor of maintenance, repair and operating supplies. In 2007, Excel had sales of approximately US\$12 million. The purchase price and costs of the acquisition were US\$6.8 million in cash and US\$0.7 million in assumed liabilities. The goodwill recognized in the transaction amounted to US\$4.4 million and is partially deductible for tax purposes.

On May 31, 2007, Lab Safety acquired substantially all of the assets and assumed certain liabilities of McFeely's Square Drive Screws (McFeely's). McFeely's is a direct marketer of specialty fasteners, hardware and tools for the professional woodworking industry. McFeely's had more than \$9 million in sales in 2006. The purchase price and costs of acquisition were \$4.7 million in cash and \$0.3 million in assumed liabilities. The goodwill recognized in the transaction amounted to \$1.2 million and is fully deductible for tax purposes.

On November 17, 2006, Lab Safety acquired substantially all of the assets and assumed certain liabilities of Professional Inspection Equipment, Inc. and Construction Book Express, Inc. The companies are direct marketers of tools, instruments and reference materials to the building and home inspection markets. The companies had annual sales in 2005 of more than \$18 million. The aggregate purchase price for the two companies was \$20.9 million in cash and \$1.7 million in assumed liabilities. The goodwill recognized in the transaction amounted to \$18.7 million and is fully deductible for tax purposes.

On January 31, 2006, Lab Safety acquired substantially all of the assets and assumed certain liabilities of Rand Materials Handling Equipment Co. (Rand). Rand is a national catalog distributor of warehouse, storage and packaging supplies. Rand had more than \$16 million in sales in 2005. The aggregate purchase price for Rand was \$13.9 million in cash and \$2.3 million in assumed liabilities. The goodwill recognized in the transaction amounted to \$9.9 million and is fully deductible for tax purposes.

The results of these acquisitions are included in the Company's consolidated results from the respective dates of acquisition. Due to the immaterial nature of these transactions, disclosures of amounts assigned to the acquired assets and assumed liabilities and pro forma results of operations were not considered necessary.

NOTE 4 – ALLOWANCE FOR DOUBTFUL ACCOUNTS

The following table shows the activity in the allowance for doubtful accounts (in thousands of dollars):

	For the Years Ended December 31,		
	2008	2007	2006
Balance at beginning of period.....	\$ 25,830	\$ 18,801	\$ 18,401
Provision for uncollectible accounts.....	12,924	15,436	6,057
Write-off of uncollectible accounts, less recoveries.....	(11,501)	(8,755)	(5,660)
Foreign currency translation impact.....	(772)	348	3
Balance at end of period.....	<u>\$ 26,481</u>	<u>\$ 25,830</u>	<u>\$ 18,801</u>

NOTE 5 – INVENTORIES

Inventories primarily consist of merchandise purchased for resale.

Inventories would have been \$317.0 million, \$287.7 million and \$270.0 million higher than reported at December 31, 2008, 2007 and 2006, respectively, if the FIFO method of inventory accounting had been used for all Company

inventories. Net earnings would have increased by \$18.1 million, \$10.8 million and \$14.5 million for the years ended December 31, 2008, 2007 and 2006, respectively, using the FIFO method of accounting. Inventory values using the FIFO method of accounting approximate replacement cost.

NOTE 6 – INVESTMENTS IN UNCONSOLIDATED ENTITIES

The table below summarizes the activity of these investments (in thousands of dollars):

	MonotaRO Co., Ltd.	MRO Korea Co., Ltd.	Asia Pacific Brands India Ltd.	USI-AGI Prairies Inc.	Total
Balance at January 1, 2006.....	\$ 2,434	\$ —	\$ —	\$ 22,721	\$ 25,155
Cash investments	3,988	—	—	—	3,988
Equity earnings.....	1,826	—	—	1,134	2,960
Divestiture.....	—	—	—	(24,967)	(24,967)
Change in interest due to issuance of stock by joint venture	453	—	—	—	453
Foreign currency gain (loss).....	(209)	—	—	1,112	903
Balance at December 31, 2006	8,492	—	—	—	8,492
Cash investments	—	2,138	—	—	2,138
Equity earnings.....	1,401	615	—	—	2,016
Reinstatement to equity method of accounting..	—	1,372	—	—	1,372
Foreign currency gain	620	121	—	—	741
Balance at December 31, 2007	\$10,513	\$4,246	\$ —	\$ —	\$ 14,759
Cash investments	—	—	6,487	—	6,487
Equity earnings (losses)	4,303	(205)	(456)	—	3,642
Write-off	—	—	(6,031)	—	(6,031)
Foreign currency gain (loss).....	3,008	(1,035)	—	—	1,973
Balance at December 31, 2008	\$17,824	\$3,006	\$ —	\$ —	\$ 20,830
Ownership interest at December 31, 2008.....	38.3%	49.0%	49.9%	0.0%	

On July 21, 2008, the Company acquired a 49.9% interest in Asia Pacific Brands India Ltd. (Asia Pacific Brands) from its sole shareholder for \$5.4 million. In addition, the Company and the joint venture partner each made a \$1.1 million capital infusion intended to help grow the business. In the fourth quarter 2008, the Company wrote-off its investment due to the economic slowdown in India and the loss of a major supplier which accounted for approximately 25% of the joint venture's annual revenue. These conditions severely affect Asia Pacific Brand's ability to secure additional financing to meet its current obligations and continue as a going concern. The Company accounted for this investment using the equity method until it was written-off.

In 2003, the Company wrote-off its investment in MRO Korea Co., Ltd. and suspended the equity method of accounting even though the business was marginally profitable and self-funding. At that time, the market value of the business was limited because the business had only one significant customer (the other party in the joint venture) and the prospects for growth were dependent upon securing sufficient capital funding. In 2007, the Company and the other business partner in the joint venture agreed to significantly change the business model and fund the expansion of this business. The Company contributed \$2.1 million to MRO Korea Co., Ltd., maintaining its 49% ownership, and resumed the equity method of accounting. In conjunction with the reinstatement of the equity accounting method, a credit was recorded to retained earnings for \$1.4 million, which represented the accumulated unrecognized equity earnings during the period the equity method was suspended and the write-down recognized in 2003.

In the first quarter of 2006, the Company contributed \$4.0 million to MonotaRO Co., Ltd., its 38.3% owned company in Japan. In the fourth quarter of 2006, an initial public offering by this company resulted in a change of interest of \$0.5 million, recorded as additional contributed capital. The market value of this investment, based on the closing stock price on January 28, 2009, was \$50.7 million.

On February 23, 2006, Acklands – Grainger Inc. (Acklands – Grainger), the Company's Canadian subsidiary, received a Notice of Purchase advising Acklands – Grainger that Uni-Select Inc., a Canadian company, was exercising its contractual option to purchase all of Acklands – Grainger's shares in the USI-AGI Prairies Inc. joint venture. The transaction closed on May 31, 2006, for Canadian \$30.9 million (US\$27.8 million), resulting in a US\$2.3 million pre-tax gain for the Company. The Company's 50% ownership investment in this joint venture was previously accounted for under the equity method of accounting. The carrying value of this investment included US\$5.1 million of allocated goodwill. The joint venture was managed by Uni-Select Inc.

NOTE 7 – CAPITALIZED SOFTWARE

Amortization of capitalized software is on a straight-line basis over three and five years. Amortization begins when the software is available for its intended use. Amortization expense was \$22.7 million, \$21.0 million and \$13.9 million for the years ended December 31, 2008, 2007 and 2006, respectively. The Company reviews the amounts capitalized for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable.

NOTE 8 – SHORT-TERM DEBT

The following summarizes information concerning short-term debt (in thousands of dollars):

	As of December 31,		
	2008	2007	2006
<u>Line of Credit</u>			
Outstanding at December 31	\$ 19,960	\$ 6,113	\$ —
Maximum month-end balance during the year	\$ 19,960	\$ 11,234	\$ —
Average amount outstanding during the year	\$ 13,022	\$ 7,756	\$ —
Weighted average interest rate during the year	6.23%	6.48%	—%
Weighted average interest rate at December 31	4.86%	6.57%	—%
<u>Commercial Paper</u>			
Outstanding at December 31	\$ —	\$ 95,947	\$ —
Maximum month-end balance during the year	\$ 319,860	\$139,104	\$ —
Average amount outstanding during the year	\$ 54,589	\$ 28,030	\$ —
Weighted average interest rate during the year	3.08%	5.38%	—%
Weighted average interest rate at December 31	—	4.30%	—%

The Company had \$29.2 million, \$31.1 million and \$8.6 million of uncommitted lines of credit denominated in foreign currencies at December 31, 2008, 2007 and 2006, respectively. At December 31, 2008, there was \$20.0 million outstanding under these lines of credit relating to Grainger China LLC. Grainger China LLC utilizes a line of credit to meet its business growth and operating needs.

Commercial paper was used to fund periodic working capital requirements and the accelerated share repurchase program. Refer to Note 13 for further discussion of the Company's share repurchase program. A portion of the proceeds from the \$500 million term loan were used to refinance \$311 million in outstanding commercial paper in May of 2008. Refer to Note 9 for further discussion on the use of proceeds from the term loan.

For 2008, 2007 and 2006, the Company had a committed line of credit totaling \$250.0 million for which the Company pays a commitment fee of 0.04% for each year. There were no borrowings under the committed line of credit.

The Company had \$18.8 million of letters of credit at December 31, 2008, and \$15.8 million of letters of credit at December 31, 2007 and 2006, primarily related to the Company's casualty insurance program. The Company also had \$6.0 million, \$3.2 million and \$3.3 million at December 31, 2008, 2007 and 2006, respectively, in letters of credit to facilitate the purchase of product from foreign sources.

NOTE 9 – LONG-TERM DEBT

Long-term debt consisted of the following (in thousands of dollars):

	As of December 31,		
	2008	2007	2006
Bank term loan	\$500,000	\$ —	\$ —
Industrial development revenue and private activity bonds	9,485	9,485	9,485
Less current maturities	(21,257)	(4,590)	(4,590)
	<u>\$488,228</u>	<u>\$ 4,895</u>	<u>\$ 4,895</u>

On May 6, 2008, the Company entered into a \$500 million, unsecured four-year bank term loan. Proceeds were used to pay down short-term debt and for general corporate purposes. The weighted average interest rate paid on the term loan during 2008 was 3.33%. The Company at its option may prepay the term loan in whole or in part.

The industrial development revenue and private activity bonds include various issues that bear interest at variable rates capped at 15%, and come due in various amounts from 2009 through 2021. The weighted average interest rate paid on the bonds during the year was 2.47%. Interest rates on some of the issues are subject to change at certain dates in the future. The bondholders may require the Company to redeem certain bonds concurrent with a change in interest rates and certain other bonds annually. In addition, \$4.6 million of these bonds had an unsecured liquidity facility

available at December 31, 2008, for which the Company compensated a bank through a commitment fee of 0.07%. There were no borrowings related to this facility at December 31, 2008. The Company classified \$4.6 million of bonds currently subject to redemption options in current maturities of long-term debt at December 31, 2008, 2007 and 2006.

The scheduled aggregate principal payments are due as follows (in thousands of dollars):

Year	Payment Amount
2009.....	\$ 18,900
2010.....	50,700
2011.....	50,900
2012.....	387,500
2013 and after	1,500

The Company's debt instruments include only standard affirmative and negative covenants that are normal in debt instruments of similar amounts and structure. The Company's debt instruments do not contain financial or performance covenants restrictive to the business of the Company, reflecting its strong financial position. The Company is in compliance with all debt covenants for the year ended December 31, 2008.

NOTE 10 – EMPLOYEE BENEFITS

Retirement Plans

A majority of the Company's employees are covered by a noncontributory profit sharing plan. This plan provides for annual employer contributions generally based upon a formula related primarily to earnings before federal income taxes, limited to a percentage of the total eligible compensation paid to all eligible employees. The plan was amended on July 30, 2008, to establish a minimum contribution of 8% and a maximum contribution of 18% of total eligible compensation paid to all eligible employees. This change was retroactive to January 1, 2008. Previously, there was no minimum percentage and the maximum percentage was 25%. The Company also sponsors additional defined contribution plans, which cover most of the other employees. Provisions under all plans were \$145.4 million, \$130.2 million and \$114.3 million for the years ended December 31, 2008, 2007 and 2006, respectively.

Postretirement Benefits

The Company has a postretirement healthcare benefits plan that provides coverage for a majority of its employees and their dependents should they elect to maintain such coverage upon retirement. Covered employees become eligible for participation when they qualify for retirement while working for the Company. Participation in the plan is voluntary and requires participants to make contributions toward the cost of the plan, as determined by the Company.

The Company's accumulated postretirement benefit obligation (APBO) and net periodic benefit costs include the effect of the federal subsidy provided by the "Medicare Prescription Drug, Improvement and Modernization Act of 2003" (the Medicare Act). The Medicare Act provides a federal subsidy to retiree healthcare benefit plan sponsors that provide a prescription drug benefit that is at least actuarially equivalent to that provided by Medicare. As a result of the subsidy, the APBO has been reduced by \$45.4 million, \$40.4 million and \$33.4 million as of December 31, 2008, 2007 and 2006, respectively. The subsidy has reduced net periodic benefits costs by approximately \$5.2 million, \$6.4 million and \$5.6 million for the years ended December 31, 2008, 2007 and 2006, respectively.

The net periodic benefits costs charged to operating expenses, which were valued with a measurement date of January 1 for each year, consisted of the following components (in thousands of dollars):

	For the Years Ended December 31,		
	2008	2007	2006
Service cost.....	\$ 9,699	\$ 10,856	\$ 9,737
Interest cost.....	9,490	8,973	7,599
Expected return on assets	(4,466)	(4,049)	(2,790)
Amortization of prior service credit	(1,215)	(437)	(858)
Amortization of transition asset	(143)	(143)	(143)
Amortization of unrecognized losses	1,312	2,094	2,903
Net periodic benefits costs	<u>\$ 14,677</u>	<u>\$ 17,294</u>	<u>\$ 16,448</u>

The Company has elected to amortize the amount of net unrecognized losses over a period equal to the average remaining service period for active plan participants expected to retire and receive benefits, or approximately 16.9 years for 2008.

Reconciliations of the beginning and ending balances of the APBO, which is calculated using a December 31 measurement date, the fair value of assets and the funded status of the benefit obligation follow (in thousands of dollars):

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Benefit obligation at beginning of year	\$150,910	\$155,353	\$127,598
Service cost	9,699	10,856	9,737
Interest cost	9,490	8,973	7,599
Plan participants' contributions	1,751	1,575	1,670
Amendments	—	(9,433)	5,559
Actuarial (gain) loss	21,443	(12,754)	7,359
Benefits paid	(4,924)	(3,929)	(4,277)
Medicare Part D Subsidy received	270	269	108
Benefit obligation at end of year	<u>188,639</u>	<u>150,910</u>	<u>155,353</u>
Fair value of plan assets at beginning of year	74,432	67,486	46,503
Actual returns on plan assets	(23,963)	2,915	6,192
Employer contributions	9,407	6,385	17,398
Plan participants' contributions	1,751	1,575	1,670
Benefits paid	(4,924)	(3,929)	(4,277)
Fair value of plan assets at end of year	<u>\$ 56,703</u>	<u>\$ 74,432</u>	<u>\$ 67,486</u>
Accrued postretirement benefits costs	<u>\$131,936</u>	<u>\$ 76,478</u>	<u>\$ 87,867</u>

The amounts recognized in Accumulated other comprehensive earnings consisted of the following components (in thousands of dollars):

	As of December 31,		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Prior service credit	\$ 9,377	\$ 10,592	\$ 1,596
Transition asset	857	1,000	1,143
Unrecognized losses	(73,966)	(25,405)	(39,119)
Deferred tax asset	24,800	5,432	14,188
Net losses	<u>\$(38,932)</u>	<u>\$ (8,381)</u>	<u>\$(22,192)</u>

The components of Accumulated other comprehensive earnings (AOCE) related to the postretirement benefit costs that will be amortized into net periodic postretirement benefit cost in 2009 are as follows (in thousands of dollars):

	<u>2009</u>
Amortization of prior service credit	\$ (1,215)
Amortization of transition asset	(143)
Amortization of unrecognized losses	<u>4,377</u>
Estimated amount to be amortized from AOCE into net periodic postretirement benefit costs	<u>\$ 3,019</u>

The benefit obligation was determined by applying the terms of the plan and actuarial models. These models include various actuarial assumptions, including discount rates, assumed rates of return on plan assets and healthcare cost trend rates. The actuarial assumptions also anticipate future cost-sharing changes to retiree contributions that will maintain the current cost-sharing ratio between the Company and the retirees. The Company evaluates its actuarial assumptions on an annual basis and considers changes in these long-term factors based upon market conditions and historical experience.

The plan amendment effective January 1, 2008 (reflected in the 2007 valuation above), changed the out-of-pocket maximums, co-payments and coinsurance amounts for retirees. The plan amendment effective January 1, 2007 (reflected in the 2006 valuation above), changed the retiree contribution percentages for certain age groups.

The following assumptions were used to determine net periodic benefit cost at January 1:

	For the Years Ended December 31,		
	2008	2007	2006
Discount rate	6.50%	5.90%	5.50%
Expected long-term rate of return on plan assets, net of tax at 40%	6.00%	6.00%	6.00%
Initial healthcare cost trend rate	10.00%	10.00%	10.00%
Ultimate healthcare cost trend rate	5.00%	5.00%	5.00%
Year ultimate healthcare cost trend rate reached	2018	2017	2016

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

	2008	2007	2006
	Discount rate	5.90%	6.50%
Expected long-term rate of return on plan assets, net of tax at 40%	6.00%	6.00%	6.00%
Initial healthcare cost trend rate	10.00%	10.00%	10.00%
Ultimate healthcare cost trend rate	5.00%	5.00%	5.00%
Year ultimate healthcare cost trend rate reached	2019	2018	2017

The discount rate assumptions reflect the rates available on high-quality fixed income debt instruments. These rates have been selected due to their similarity to the projected cash flows of the postretirement healthcare benefit plan.

The Company reviews external data and its own historical trends for healthcare costs to determine the healthcare cost trend rates. Assumed healthcare cost trend rates have a significant effect on the amounts reported for the healthcare plans. A 1 percentage point change in assumed healthcare cost trend rates would have the following effects on December 31, 2008 results (in thousands of dollars):

	1 Percentage Point	
	Increase	(Decrease)
Effect on total of service and interest cost	\$ 4,206	\$ (3,293)
Effect on accumulated postretirement benefit obligation	37,268	(29,601)

The Company has established a Group Benefit Trust to fund the plan and process benefit payments. The assets of the trust are invested entirely in funds designed to track the Standard & Poor's 500 Index (S&P 500). This investment strategy reflects the long-term nature of the plan obligation and seeks to take advantage of the superior earnings potential of equity securities. The Company uses the long-term historical return on the plan assets and the historical performance of the S&P 500 to develop its expected return on plan assets. The required use of an expected long-term rate of return on plan assets may result in recognizing income that is greater or less than the actual return on plan assets in any given year. Over time, however, the expected long-term returns are designed to approximate the actual long-term returns and, therefore, result in a pattern of income recognition that more closely matches the pattern of the services provided by the employees.

The funding of the trust is an estimated amount which is intended to allow the maximum deductible contribution under the Internal Revenue Code of 1986 (IRC), as amended, and was \$9.4 million, \$6.4 million and \$17.4 million for the years ended December 31, 2008, 2007 and 2006, respectively. There are no minimum funding requirements and the Company intends to follow its practice of funding the maximum deductible contribution under the IRC.

The Company forecasts the following benefit payments (which include a projection for expected future employee service) and subsidy receipts (in thousands of dollars):

	Estimated gross benefit payments	Estimated Medicare subsidy receipts
2009.....	\$ 3,852	\$ (414)
2010.....	4,436	(497)
2011.....	5,173	(587)
2012.....	5,989	(694)
2013.....	7,017	(809)
2014 – 2018.....	56,046	(6,507)

Executive Death Benefit Plan

The Executive Death Benefit Plan provides one of three potential benefits: a supplemental income benefit (SIB), an executive death benefit (EDB) or a postretirement payment. The SIB provides income continuation at 50% of total compensation, payable for ten years to the beneficiary of a participant if that participant dies while employed by the Company. Alternatively, the EDB provides an after-tax lump sum payment of one times final total compensation to the beneficiary of a participant who dies after retirement. In addition, a participant may elect to receive a reduced postretirement payment instead of the EDB. Effective October 29, 2008, new participants to the plan will not be eligible for the postretirement payment option. Plan participation is determined by a committee of management. There are no plan assets. Benefits are paid as they come due from the general assets of the Company.

The net periodic benefits costs charged to operating expenses, which were valued with a measurement date of January 1 for each year, consisted of the following components (in thousands of dollars):

	For the Years Ended December 31,		
	2008	2007	2006
Service cost.....	\$ 247	\$ 298	\$ 361
Interest cost.....	880	883	850
Amortization of unrecognized (gains) losses.....	(153)	127	154
Net periodic benefits costs.....	<u>\$ 974</u>	<u>\$ 1,308</u>	<u>\$ 1,365</u>

Reconciliations of the beginning and ending balances of the projected benefit obligation, which are calculated using a December 31 measurement date follow (in thousands of dollars):

	2008	2007	2006
Benefit obligation at beginning of year.....	\$ 14,115	\$ 14,906	\$ 15,222
Service cost.....	247	298	361
Interest cost.....	880	883	850
Actuarial (gains) losses.....	1,425	(1,972)	(1,095)
Benefits paid.....	(579)	—	(432)
Benefit obligation at end of year.....	<u>\$ 16,088</u>	<u>\$ 14,115</u>	<u>\$ 14,906</u>

As there are no plan assets, the benefits were paid from the general assets of the Company.

The amounts recognized as the current and long-term portions of the benefit obligation follow (in thousands of dollars):

	As of December 31,		
	2008	2007	2006
Current liabilities.....	\$ 552	\$ 739	\$ 454
Noncurrent liabilities.....	15,536	13,376	14,452
Net amounts recognized.....	<u>\$16,088</u>	<u>\$14,115</u>	<u>\$14,906</u>

Net gains and losses recognized in Accumulated other comprehensive earnings were gains of \$0.3 million and \$1.9 million and losses of \$0.2 million as of December 31, 2008, 2007 and 2006, respectively.

The net gain that will be amortized from Accumulated other comprehensive earnings into net periodic benefit cost in 2009 is \$24.5 thousand.

The benefit obligation was determined by applying the terms of the plan and actuarial models. These models include various actuarial assumptions, including discount rates, mortality and salary progression. The Company evaluates its actuarial assumptions on an annual basis and considers changes in these long-term factors based upon market conditions and historical experience.

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

	2008	2007	2006
Discount rate used to determine net periodic benefit cost (January 1 valuation).....	6.40%	5.90%	5.50%
Discount rate used to determine benefit obligation (December 31 valuation).....	6.10%	6.40%	5.90%
Compensation increase used to determine obligation and cost.....	4.00%	4.00%	4.00%

The discount rate assumptions reflect the rates available on high-quality fixed income debt instruments. These rates have been selected due to their similarity to the projected cash flows of the Executive Death Benefit Plan.

Actuarially projected future benefit payments are as follows (in thousands of dollars):

	<u>Benefit Payments</u>
2009	\$ 553
2010	608
2011	665
2012	729
2013	803
2014 – 2018	5,269

Deferred Compensation Plans

The Executive Deferred Compensation Plans are money purchase defined benefit plans. Plan participation was limited to Company executives during the years 1984 to 1986; no new executives have been added since that time. Participants were allowed to defer a portion of their compensation for the years 1984 through 1990. In return, under the plan, each participant receives an individually specified benefit at age 65. Benefits are reduced when the participant elects early retirement. There are no plan assets. Benefits are paid as they come due from the general assets of the Company.

The net periodic benefits costs charged to operating expenses, which were valued with a measurement date of January 1 for each year, consisted of the following components (in thousands of dollars):

	<u>For the Years Ended December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Interest cost	\$ 543	\$ 568	\$ 573
Amortization of unrecognized losses	40	59	184
Net periodic benefits costs	<u>\$ 583</u>	<u>\$ 627</u>	<u>\$ 757</u>

Reconciliations of the beginning and ending balances of the projected benefit obligation, which is calculated using a December 31 measurement date, and the status of the benefit obligation follow (in thousands of dollars):

	<u>2008</u>	<u>2007</u>	<u>2006</u>
Benefit obligation at beginning of year	\$10,151	\$10,945	\$ 11,419
Interest cost	543	568	573
Actuarial (gains) losses	(135)	(104)	129
Benefits paid	<u>(1,226)</u>	<u>(1,258)</u>	<u>(1,176)</u>
Benefit obligation at end of year	<u>\$ 9,333</u>	<u>\$10,151</u>	<u>\$10,945</u>

As there are no plan assets, the benefits were paid from the general assets of the Company.

The amounts recognized as the current and long-term portions of the benefit obligation follow (in thousands of dollars):

	<u>As of December 31,</u>		
	<u>2008</u>	<u>2007</u>	<u>2006</u>
Current liabilities	\$ 1,226	\$ 1,226	\$ 1,229
Noncurrent liabilities	8,107	8,925	9,716
Net amounts recognized	<u>\$ 9,333</u>	<u>\$10,151</u>	<u>\$10,945</u>

Net losses recognized in Accumulated other comprehensive earnings were \$0.2 million, \$0.4 million and \$0.3 million as of December 31, 2008, 2007 and 2006, respectively.

The net loss that will be amortized from Accumulated other comprehensive earnings into net periodic benefit cost in 2009 is \$22.9 thousand.

The benefit obligation was determined by applying the terms of the plan and actuarial models. These models include various actuarial assumptions, including discount rates, mortality and retirement age. The Company evaluates its actuarial assumptions on an annual basis and considers changes in these long-term factors based upon market conditions and historical experience.

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

	2008	2007	2006
Discount rate used to determine net periodic benefit cost (January 1 valuation).....	5.70%	5.50%	5.25%
Discount rate used to determine benefit obligation (December 31 valuation).....	6.00%	5.70%	5.50%

The discount rate assumptions reflect the rates available on high-quality fixed income debt instruments. These rates have been selected due to their similarity to the projected cash flows of the Executive Deferred Compensation Plans. Actuarially projected future benefit payments are as follows (in thousands of dollars):

	Benefit Payments
2009.....	\$1,226
2010.....	1,196
2011.....	1,162
2012.....	1,154
2013.....	1,155
2014 – 2018.....	4,858

Other Employment-Related Benefit Plans

Certain of the Company's non-U.S. subsidiaries provide limited non-pension benefits to retirees in addition to government-mandated programs. The cost of these programs is not significant to the Company. Most retirees outside the United States are covered by government-sponsored and -administered programs.

NOTE 11 – LEASES

The Company leases certain land, buildings and equipment under noncancellable operating leases that expire at various dates through 2036. The Company capitalizes all significant leases that qualify for capitalization, of which there were none at December 31, 2008. Many of the building leases obligate the Company to pay real estate taxes, insurance and certain maintenance costs, and contain multiple renewal provisions, exercisable at the Company's option. Leases that contain predetermined fixed escalations of the minimum rentals are recognized in rental expense on a straight-line basis over the lease term. Cash or rent abatements received upon entering into certain operating leases are also recognized on a straight-line basis over the lease term.

At December 31, 2008, the approximate future minimum lease payments for all operating leases were as follows (in thousands of dollars):

	Future Minimum Lease Payments
2009.....	\$ 41,150
2010.....	35,718
2011.....	30,753
2012.....	26,658
2013.....	23,259
Thereafter.....	60,837
Total minimum payments required.....	\$218,375
Less amounts representing sublease income.....	(227)
	<u>\$218,148</u>

Rent expense, including items under lease and items rented on a month-to-month basis, was \$44.8 million, \$42.1 million and \$33.4 million for 2008, 2007 and 2006, respectively. These amounts are net of sublease income of \$0.6 million, \$0.5 million and \$0.5 million for 2008, 2007 and 2006, respectively.

NOTE 12 – STOCK INCENTIVE PLANS

The Company maintains stock incentive plans under which the Company may grant a variety of incentive awards to employees and directors. Shares of common stock were authorized for issuance under the plans in connection with awards of non-qualified stock options, stock appreciation rights, restricted stock, restricted stock units and other stock-based awards. As of December 31, 2008, restricted stock, restricted stock units, performance shares, stock units and non-qualified stock options have been granted.

In 2005, the shareholders of the Company approved the 2005 Incentive Plan ("Plan"), which replaced all prior active plans ("Prior Plans"). Awards previously granted under Prior Plans will remain outstanding in accordance with their

terms. The Plan authorizes the granting of options to purchase shares at a price of not less than 100% of the closing market price on the last trading day preceding the date of grant. All options expire no later than ten years after the date of grant. A total of 9.5 million shares of common stock have been reserved for issuance under the Plan. As of December 31, 2008, there were 2,548,950 shares available for grant under the Plan.

Effective January 1, 2006, the Company adopted the Financial Accounting Standards Board's Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123R) using the modified prospective method. Under this transition method, compensation cost recognized in 2008, 2007 and 2006 includes: (a) compensation costs for all share-based payments granted prior to, but not fully vested as of January 1, 2006, based on the grant date fair value as calculated under the pro forma disclosure-only expense provisions of SFAS No. 123 and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with provisions of SFAS No. 123R.

Pre-tax stock-based compensation expense was \$46.1 million, \$35.7 million and \$34.8 million in 2008, 2007 and 2006, respectively. Related income tax benefits recognized in earnings were \$18.2 million, \$11.8 million and \$11.8 million in 2008, 2007 and 2006, respectively.

Options

In 2008, 2007 and 2006, the Company provided broad-based stock option grants of 161,400, 162,100 and 187,900 shares, respectively, to those employees who reached major service milestones and were not participants in other stock option programs.

In 2008, 2007 and 2006, the Company issued stock option grants to participating employees as part of their incentive compensation. Stock option grants were 721,600, 578,120 and 1,234,400 for the years 2008, 2007 and 2006, respectively.

Option awards are granted with an exercise price equal to the closing market price of the Company's stock on the last trading day preceding the date of grant. The options generally vest over three years, although accelerated vesting is provided in certain circumstances. Awards generally expire ten years from the grant date.

Transactions involving stock options are summarized as follows:

	Shares Subject to Option	Weighted Average Price Per Share	Options Exercisable
Outstanding at January 1, 2006	8,691,840	\$48.37	<u>4,572,250</u>
Granted	1,422,300	\$75.87	
Exercised	(1,390,461)	\$46.35	
Canceled or expired	<u>(268,810)</u>	\$57.88	
Outstanding at December 31, 2006	8,454,869	\$53.00	<u>4,627,249</u>
Granted	740,220	\$82.21	
Exercised	(2,430,523)	\$47.74	
Canceled or expired	<u>(236,580)</u>	\$67.29	
Outstanding at December 31, 2007	6,527,986	\$58.19	<u>3,447,856</u>
Granted	883,000	\$84.58	
Exercised	(953,199)	\$50.07	
Canceled or expired	<u>(103,920)</u>	\$73.14	
Outstanding at December 31, 2008	<u>6,353,867</u>	\$62.95	<u>3,633,612</u>

At December 31, 2008, there was \$13.2 million of total unrecognized compensation expense related to nonvested option awards, which the Company expects to recognize over a weighted average period of 1.7 years.

The following table summarizes information about stock options exercised (in thousands of dollars):

	For the Years Ended December 31,		
	2008	2007	2006
Fair value of options exercised	\$ 12,752	\$ 31,736	\$ 18,152
Total intrinsic value of options exercised	35,095	88,921	38,906
Fair value of options vested	15,510	15,996	15,295
Settlements of options exercised	47,016	113,752	64,437

Information about stock options outstanding and exercisable as of December 31, 2008, is as follows:

Range of Exercise Prices	Options Outstanding				Options Exercisable			
	Weighted Average				Weighted Average			
	Number	Remaining Contractual Life	Exercise Price	Intrinsic Value (000's)	Number	Remaining Contractual Life	Exercise Price	Intrinsic Value (000's)
\$37.50 – \$44.05	742,155	2.0 Years	\$40.55	\$ 28,419	742,155	2.0 Years	\$40.55	\$ 28,419
\$45.50 – \$54.85	2,707,052	4.6 Years	\$51.49	74,051	2,705,992	4.6 Years	\$51.49	74,019
\$56.03 – \$70.67	139,815	6.1 Years	\$62.08	2,343	138,815	6.1 Years	\$62.02	2,335
\$71.21 – \$93.05	2,764,845	8.2 Years	\$80.24	(3,875)	46,650	7.7 Years	\$77.69	54
	<u>6,353,867</u>	5.9 Years	\$62.95	<u>\$100,938</u>	<u>3,633,612</u>	4.2 Years	\$49.99	<u>\$104,827</u>

The Company uses a binomial lattice model for the valuation of stock options. The weighted average fair value of options granted in 2008, 2007 and 2006 was \$20.82, \$22.92 and \$18.91, respectively. The fair value of each option granted used the following assumptions:

	For the Years Ended December 31,		
	2008	2007	2006
Risk-free interest rate.....	3.2%	4.6%	4.9%
Expected life.....	6 years	6 years	6 years
Expected volatility.....	25.2%	24.3%	23.9%
Expected dividend yield.....	1.8%	1.7%	1.5%

The risk-free interest rate is selected based on yields from U.S. Treasury zero-coupon issues with a remaining term approximately equal to the expected term of the options being valued. The expected life selected for options granted during each year presented represents the period of time that the options are expected to be outstanding based on historical data of option holder exercise and termination behavior. Expected volatility is based upon implied and historical volatility of the closing price of the Company's stock over a period equal to the expected life of each option grant. Historical company information is also the primary basis for selection of expected dividend yield assumptions.

Performance Shares

In 2008, 2007 and 2006, the Company awarded performance-based shares to certain executives. Receipt of Company stock is contingent upon the Company meeting sales growth and return on invested capital (ROIC) performance goals. Each participant was granted a base number of shares. At the end of the first year performance period, the number of shares granted will be increased, decreased or remain the same based upon actual Company-wide sales growth versus target sales growth. The shares, as determined at the end of the performance year, will be issued at the end of the third year if the Company's average target ROIC is achieved during the vesting period.

Performance share value is based upon closing market prices on the last trading day preceding the date of award and is charged to earnings on a straight-line basis over the three year period. Holders of performance shares are entitled to receive cash payments equivalent to cash dividends after the end of the first year performance period. If the performance shares vest, they will be settled by the issuance of Company common stock in exchange for the performance shares on a one-for-one basis.

The following table summarizes the transactions involving performance-based share awards:

	2008		2007		2006	
	Shares	Weighted Average	Shares	Weighted Average	Shares	Weighted Average
Beginning nonvested shares						
outstanding	116,796	\$69.49	37,812	\$71.23	—	\$ —
Issuances	38,360	\$86.00	83,089	\$68.64	37,812	\$71.23
Cancellations.....	—	\$ —	(4,105)	\$69.00	—	\$ —
Vestings.....	(37,260)	\$71.23	—	\$ —	—	\$ —
Ending nonvested shares						
outstanding	<u>117,896</u>	\$75.13	<u>116,796</u>	\$69.49	<u>37,812</u>	\$71.23

At December 31, 2008, the unearned compensation related to performance-based share awards outstanding was \$3.8 million, which the Company expects to recognize over a weighted average period of 1.7 years.

Restricted Stock

The plans authorize the granting of restricted stock, which is held by the Company pursuant to the terms and conditions related to the applicable grants. Except for the right of disposal, holders of restricted stock have full shareholders' rights during the period of restriction, including voting rights and the right to receive dividends. Restricted stock grants have original vesting periods of six to ten years.

Compensation expense related to restricted stock awards is based upon the closing market price on the last trading day preceding the date of grant and is charged to earnings on a straight-line basis over the vesting period. The following table summarizes the transactions involving restricted stock granted to employees:

	2008		2007		2006	
	Shares	Weighted Average	Shares	Weighted Average	Shares	Weighted Average
Beginning nonvested shares						
outstanding	65,000	\$52.37	105,000	\$51.05	270,000	\$44.75
Cancellations.....	—	\$ —	—	\$ —	(10,000)	\$57.07
Vesting.....	(15,000)	\$48.15	(40,000)	\$48.73	(155,000)	\$37.91
Ending nonvested shares						
outstanding	50,000	\$53.50	65,000	\$52.37	105,000	\$51.05
Fair value of shares vested	\$1.3 million		\$3.0 million		\$11.1 million	

At December 31, 2008, there was \$0.1 million of total unrecognized compensation expense related to nonvested restricted stock, which the Company expects to recognize over a weighted average period of 0.7 years.

Restricted Stock Units (RSUs)

Awards of RSUs are provided for under the stock compensation plans. RSUs granted vest over periods from two to seven years from issuance, although accelerated vesting is provided in certain instances. Holders of RSUs are entitled to receive cash payments equivalent to cash dividends and other distributions paid with respect to common stock. At various times after vesting, RSUs will be settled by the issuance of stock evidencing the conversion of the RSUs into shares of the Company common stock on a one-for-one basis. Compensation expense related to RSUs is based upon the closing market prices on the last trading day preceding the date of award and is charged to earnings on a straight-line basis over the vesting period.

The following table summarizes RSUs activity:

	2008		2007		2006	
	Shares	Weighted Average	Shares	Weighted Average	Shares	Weighted Average
Beginning nonvested units.....	982,568	\$72.91	740,200	\$65.24	517,000	\$49.74
Issuances	460,423	\$84.35	421,003	\$83.53	408,300	\$75.54
Cancellations.....	(33,490)	\$78.72	(74,030)	\$71.99	(26,750)	\$66.84
Vestings.....	(172,255)	\$64.37	(104,605)	\$75.85	(158,350)	\$58.68
Ending nonvested units.....	1,237,246	\$77.88	982,568	\$72.91	740,200	\$65.24
Fair value of shares vested	\$11.1 million		\$7.5 million		\$8.4 million	

At December 31, 2008, there was \$47.3 million of total unrecognized compensation expense related to nonvested RSUs which the Company expects to recognize over a weighted average period of 3.0 years.

Director Stock Awards

The Company provides members of the Board of Directors with deferred stock unit grants. A stock unit is the economic equivalent of a share of common stock. Beginning in April 2008, the number of units covered by each grant is equal to \$100,000 divided by the fair market value of a share of common stock at the time of the grant, rounded up to the next ten-unit increment. Prior to April 2008, the number of units covered by each grant was equal to \$60,000 divided by the fair market value of a share of common stock at the time of the grant, rounded up to the next ten-unit increment. The Company also awards stock units in connection with elective deferrals of director fees and dividend equivalents on existing stock units. Deferred fees and dividend equivalents on existing stock units are converted into stock units on the basis of the market value of the stock at the relevant times. Payment of the value of stock units is scheduled to be made after termination of service as a director. As of December 31, 2008, 2007 and 2006, there were eleven nonemployee directors who held stock units.

The Company recognizes income (expense) for the change in value of equivalent stock units. The following table summarizes activity for stock units related to deferred director fees (dollars in thousands):

	2008		2007		2006	
	Units	Dollars	Units	Dollars	Units	Dollars
Beginning balance.....	74,522	\$ 6,522	61,242	\$ 4,283	51,977	\$ 3,696
Dividends.....	1,692	137	1,099	95	902	64
Deferred fees.....	17,007	1,460	12,181	1,012	14,844	1,128
Retirement distributions.....	—	—	—	—	(6,481)	(461)
Unit appreciation (depreciation).....	—	(769)	—	1,132	—	(144)
Ending balance.....	<u>93,221</u>	<u>\$ 7,350</u>	<u>74,522</u>	<u>\$ 6,522</u>	<u>61,242</u>	<u>\$ 4,283</u>

NOTE 13 – CAPITAL STOCK

The Company had no shares of preferred stock outstanding as of December 31, 2008, 2007 and 2006. The activity of outstanding common stock and common stock held in treasury was as follows:

	2008		2007		2006	
	Outstanding Common Stock	Treasury Stock	Outstanding Common Stock	Treasury Stock	Outstanding Common Stock	Treasury Stock
Balance at beginning of period	79,459,415	30,199,804	84,067,627	25,590,311	89,715,641	19,952,297
Exercise of stock options, net of 2,725, 3,318 and 0 shares swapped in stock-for-stock exchange	950,474	(950,474)	2,427,205	(2,427,205)	1,390,461	(1,390,461)
Cancellation of shares related to tax withholdings on restricted stock vesting.....	(4,874)	4,874	(14,867)	14,867	(59,297)	59,297
Settlement of restricted stock units, net of 48,488, 16,739, and 6,228 shares retained, respectively.....	101,962	(101,962)	31,057	(29,776)	13,822	(13,822)
Cancellation of restricted shares	—	—	—	—	(10,000)	—
Purchase of treasury shares	(5,725,948)	5,725,948	(7,051,607)	7,051,607	(6,983,000)	6,983,000
Balance at end of period	<u>74,781,029</u>	<u>34,878,190</u>	<u>79,459,415</u>	<u>30,199,804</u>	<u>84,067,627</u>	<u>25,590,311</u>

On August 20, 2007, the Company entered into an accelerated share repurchase agreement (ASR) with Goldman, Sachs & Co. (Goldman) to purchase \$500 million of its outstanding common stock. The Company paid Goldman \$500 million on August 23, 2007, in exchange for an initial delivery of 5,316,007 shares. The ASR was treated as an equity transaction. At settlement, the Company was to receive or pay additional shares of its common stock or cash (at Grainger's option), based upon the volume weighted average price during the term of the agreement. Accordingly, on January 4, 2008, the Company received 415,274 shares of its common stock from Goldman as final settlement of the ASR. A total of 5,731,281 shares were repurchased under the ASR.

NOTE 14 – ACCUMULATED OTHER COMPREHENSIVE EARNINGS

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

	As of December 31,		
	2008	2007	2006
Foreign currency translation adjustments	\$ 3,943	\$94,683	\$31,859
Effect of adopting SFAS No. 158 related to postretirement benefit plans and other employment-related benefit plans	—	—	(36,783)
Postretirement benefit plan			
Prior service credit	9,377	10,592	—
Transition asset.....	857	1,000	—
Unrecognized (losses)	(73,966)	(25,405)	—
Unrecognized gains (losses) on other employment-related benefit plans.....	(68)	1,335	(524)
Deferred tax asset (liability).....	21,332	(10,034)	8,879
Total accumulated other comprehensive earnings (losses).....	<u>\$(38,525)</u>	<u>\$72,171</u>	<u>\$ 3,431</u>

Foreign currency translation adjustments result from the translation of assets and liabilities of foreign subsidiaries. The decrease in foreign currency translation adjustments in 2008 is primarily due to the strengthening of the U.S. dollar versus the Canadian dollar and Mexican peso.

In 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans – an amendment of FASB Statements No. 87, 88, 106, and 132R" (SFAS No. 158). SFAS No. 158 requires an employer to recognize in its statement of financial position an asset for a plan's overfunded status or a liability for a plan's underfunded status, measure a plan's assets and its obligations that determine its funded status as of the end of the employer's fiscal year (with limited exceptions), and recognize changes in the funded status of a defined benefit postretirement plan in the year in which the changes occur. SFAS No. 158 requires recognition of funded status changes of a defined benefit postretirement and other employment-related benefit plans within accumulated other comprehensive earnings, net of tax, to the extent such changes are not recognized in earnings as components of net periodic benefit costs. The Company adopted SFAS No. 158 in 2006 and recorded an additional liability of \$36.8 million to Accrued employment-related benefit costs offset by \$14.3 million of deferred income taxes and a reduction of Accumulated other comprehensive earnings. The increase in unrecognized losses in 2008 is primarily due to the impact of a reduction in discount rates and losses on plan assets.

NOTE 15 – INCOME TAXES

The Company recognizes deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial reporting and tax bases of assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse.

Income tax expense consisted of the following (in thousands of dollars):

	For the Years Ended December 31,		
	2008	2007	2006
Current provision:			
Federal	\$246,731	\$238,220	\$172,961
State	39,673	42,401	31,725
Foreign	18,044	15,329	5,080
Total current.....	304,448	295,950	209,766
Deferred tax provision (benefit):			
Federal	(5,968)	(28,520)	8,996
State	(1,049)	(5,013)	1,636
Foreign	432	(676)	(774)
Total deferred	(6,585)	(34,209)	9,858
Total provision.....	<u>\$297,863</u>	<u>\$261,741</u>	<u>\$219,624</u>

Earnings before income taxes by geographical area consisted of the following (in thousands of dollars):

	For the Years Ended December 31,		
	2008	2007	2006
United States	\$731,315	\$646,762	\$588,322
Foreign	41,903	35,099	14,701
	<u>\$773,218</u>	<u>\$681,861</u>	<u>\$603,023</u>

The income tax effects of temporary differences that gave rise to the net deferred tax asset were (in thousands of dollars):

	As of December 31,		
	2008	2007	2006
Deferred tax assets:			
Inventory	\$ 22,674	\$ 19,577	\$ 13,809
Accrued expenses	29,966	30,295	28,606
Accrued employment-related benefits	144,125	111,147	99,006
Foreign operating loss carryforwards	10,833	10,239	9,530
Property, buildings and equipment	921	3,189	—
Other	11,352	8,064	8,582
Deferred tax assets	219,871	182,511	159,533
Less valuation allowance	(15,977)	(13,551)	(13,461)
Deferred tax assets, net of valuation allowance	<u>\$203,894</u>	<u>\$168,960</u>	<u>\$146,072</u>
Deferred tax liabilities:			
Purchased tax benefits	\$ (5,812)	\$ (6,779)	\$ (7,715)
Property, buildings and equipment	—	—	(4,303)
Intangibles	(17,083)	(16,884)	(14,182)
Software	(12,774)	(9,710)	(10,627)
Prepays	(21,893)	(16,625)	(14,111)
Foreign currency gain	(2,206)	(13,661)	(4,453)
Deferred tax liabilities	<u>(59,768)</u>	<u>(63,659)</u>	<u>(55,391)</u>
Net deferred tax asset	<u>\$144,126</u>	<u>\$105,301</u>	<u>\$ 90,681</u>
The net deferred tax asset is classified as follows:			
Current assets	\$ 52,556	\$ 56,663	\$ 48,123
Noncurrent assets	97,442	54,658	48,793
Noncurrent liabilities (foreign)	(5,872)	(6,020)	(6,235)
Net deferred tax asset	<u>\$144,126</u>	<u>\$105,301</u>	<u>\$ 90,681</u>

At December 31, 2008, the Company had \$34.8 million of foreign operating loss carryforwards related to foreign operations, some of which begin to expire in 2009. The valuation allowance represents a provision for uncertainty as to the realization of the tax benefits of these carryforwards. In addition, the Company recorded a valuation allowance to reflect the estimated amount of deferred tax assets that may not be realized.

The changes in the valuation allowance were as follows (in thousands of dollars):

	For the Years Ended December 31,		
	2008	2007	2006
Beginning balance	\$ 13,551	\$ 13,461	\$ 10,872
Increase (decrease) related to foreign net operating loss carryforwards	86	1,329	(70)
Increase (decrease) related to capital losses and other	2,340	(1,239)	2,659
Ending balance	<u>\$ 15,977</u>	<u>\$ 13,551</u>	<u>\$ 13,461</u>

A reconciliation of income tax expense with federal income taxes at the statutory rate follows (in thousands of dollars):

	For the Years Ended December 31,		
	2008	2007	2006
Federal income tax at the 35% statutory rate.....	\$270,626	\$238,651	\$211,058
State income taxes, net of federal income tax benefit	25,105	24,302	22,795
Resolution of prior year tax contingencies	—	—	(12,200)
Other – net	2,132	(1,212)	(2,029)
Income tax expense	<u>\$297,863</u>	<u>\$261,741</u>	<u>\$219,624</u>
Effective tax rate	<u>38.5%</u>	<u>38.4%</u>	<u>36.4%</u>

Undistributed earnings of foreign subsidiaries at December 31, 2008, amounted to \$31.5 million. No provision for deferred U.S. income taxes has been made for these subsidiaries because the Company intends to permanently reinvest such earnings in those foreign operations.

On January 1, 2007, the Company adopted the provisions of FIN 48. As a result, the Company recognized a decrease of approximately \$0.9 million in the liability for tax uncertainties, which resulted in an increase to the January 1, 2007, balance of Retained earnings.

The changes in the liability for tax uncertainties, excluding interest, are as follows (in thousands of dollars):

	2008	2007
Balance at beginning of year	\$13,568	\$15,274
Additions based on tax positions related to the current year	13,016	3,060
Additions for tax positions of prior years	735	—
Reductions for tax positions of prior years	(2,900)	(4,729)
Settlements (audit payments) refunds – net	(55)	(37)
Balance at end of year	<u>\$24,364</u>	<u>\$13,568</u>

The Company classifies the liability for tax uncertainties in Deferred income taxes and tax uncertainties. Included in this amount is \$7.4 million and \$3.3 million at December 31, 2008 and 2007, respectively, of tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. Any changes in the timing of deductibility of these items would not affect the annual effective tax rate but would accelerate the payment of cash to the taxing authorities to an earlier period.

The Company regularly undergoes examination of its federal income tax returns by the Internal Revenue Service (IRS). The Company and the IRS have settled tax years through 2004. The Company is not currently under examination by the IRS nor under notice of a pending examination. The Company is also subject to state and local income tax audits and foreign jurisdiction tax audits. The Company's tax years 2002 – 2008 remain subject to state and local audits. Tax years 2003 – 2008 remain open to foreign audits. The Company's estimated amount of liability associated with the Company's uncertain tax positions may decrease within the next twelve months due to expiring statutes, tax payments or audit activity.

The Company recognizes interest expense in the provision for income taxes. During 2008 and 2007, the Company recognized interest of \$0.8 million and \$0.7 million, respectively. As of December 31, 2008 and 2007, respectively, the Company accrued \$1.9 million and \$1.1 million for interest.

NOTE 16 – EARNINGS PER SHARE

Basic earnings per share is based on the weighted average number of shares outstanding during the year. Diluted earnings per share is based on the combination of weighted average number of shares outstanding and dilutive potential shares. The Company had outstanding stock options of 2.6 million, 0.01 million and 1.36 million for the years ended December 31, 2008, 2007 and 2006, respectively, that were excluded from the computation of diluted earnings per share because the options' exercise price was greater than the average market price of the common stock.

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except for per share amounts):

	For the Years Ended December 31,		
	2008	2007	2006
Net earnings	\$475,355	\$420,120	\$383,399
Denominator for basic earnings per share – weighted average shares	76,580	82,404	87,839
Effect of dilutive securities – stock-based compensation	2,170	2,641	2,685
Denominator for diluted earnings per share – weighted average shares adjusted for dilutive securities	78,750	85,045	90,524
Basic earnings per common share	\$ 6.21	\$ 5.10	\$ 4.36
Diluted earnings per common share	\$ 6.04	\$ 4.94	\$ 4.24

NOTE 17 – PREFERRED SHARE PURCHASE RIGHTS

The Company has a shareholder rights plan, under which there is outstanding one preferred share purchase right (Right) for each outstanding share of the Company's common stock. Each Right, under certain circumstances, may be exercised to purchase one one-hundredth of a share of Series A-1999 Junior Participating Preferred Stock (intended to be the economic equivalent of one share of the Company's common stock) at a price of \$250.00, subject to adjustment. The Rights become exercisable only after a person or group, other than a person or group exempt under the plan, acquires or announces a tender offer for 15% or more of the Company's common stock. If a person or group, other than a person or group exempt under the plan, acquires 15% or more of the Company's common stock or if the Company is acquired in a merger or other business combination transaction, each Right generally entitles the holder, other than such person or group, to purchase, at the then-current exercise price, stock and/or other securities or assets of the Company or the acquiring company having a market value of twice the exercise price.

The Rights expire on May 15, 2009, unless earlier redeemed. They generally are redeemable at \$.001 per Right until thirty days following announcement that a person or group, other than a person or group exempt under the plan, has acquired 15% or more of the Company's common stock. The Rights do not have voting or dividend rights and, until they become exercisable, have no dilutive effect on the earnings of the Company.

NOTE 18 – SEGMENT INFORMATION

The Company has three reportable segments: Grainger Branch-based, Acklands – Grainger Branch-based and Lab Safety. Grainger Branch-based is an aggregation of the following business units which offer similar services and products: Grainger Industrial Supply, Grainger, S.A. de C.V. (Mexico), Grainger Caribe Inc. (Puerto Rico), Grainger China LLC (China) and Grainger Panama S.A. (Panama). Acklands – Grainger is the Company's Canadian branch-based distribution business. Lab Safety is a direct marketer of safety and other industrial products. During 2009, Grainger will be integrating the Lab Safety business into the Grainger Industrial Supply business as well as reviewing the Company's current operating structure to ensure that it will meet the current and future needs of the business. The Company is also evaluating the impact that this integration will have on reportable segments. Any changes to reportable segments will include a restatement of prior periods for consistency purposes.

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. Intersegment transfer prices are established at external selling prices, less costs not incurred due to a related party sale.

The following is the segment information (in thousands of dollars):

	2008			
	Grainger Branch-based	Acklands – Grainger Branch-based	Lab Safety	Total
Total net sales.....	\$5,678,823	\$727,989	\$450,725	\$6,857,537
Intersegment net sales.....	(3,556)	(127)	(3,822)	(7,505)
Net sales to external customers.....	5,675,267	727,862	446,903	6,850,032
Segment operating earnings.....	782,747	54,263	45,386	882,396
Segment assets.....	2,216,282	448,660	225,494	2,890,436
Depreciation and amortization.....	107,367	10,506	9,333	127,206
Additions to long-lived assets.....	\$ 166,807	\$ 24,337	\$ 15,337	\$ 206,481
	2007			
	Grainger Branch-based	Acklands – Grainger Branch-based	Lab Safety	Total
Total net sales.....	\$5,352,520	\$636,524	\$434,663	\$6,423,707
Intersegment net sales.....	(1,997)	—	(3,696)	(5,693)
Net sales to external customers.....	5,350,523	636,524	430,967	6,418,014
Segment operating earnings.....	669,441	44,218	54,287	767,946
Segment assets.....	2,107,408	502,414	212,627	2,822,449
Depreciation and amortization.....	100,082	10,786	9,126	119,994
Additions to long-lived assets.....	\$ 155,936	\$ 10,794	\$ 7,844	\$ 174,574
	2006			
	Grainger Branch-based	Acklands – Grainger Branch-based	Lab Safety	Total
Total net sales.....	\$4,910,836	\$565,098	\$411,511	\$5,887,445
Intersegment net sales.....	(1,214)	—	(2,577)	(3,791)
Net sales to external customers.....	4,909,622	565,098	408,934	5,883,654
Segment operating earnings.....	593,455	15,242	52,283	660,980
Segment assets.....	1,938,270	394,707	215,515	2,548,492
Depreciation and amortization.....	88,753	9,505	8,099	106,357
Additions to long-lived assets.....	\$ 112,414	\$ 8,238	\$ 37,733	\$ 158,385

Following are reconciliations of the segment information with the consolidated totals per the financial statements (in thousands of dollars):

	2008	2007	2006
Operating earnings:			
Total operating earnings for reportable segments	\$ 882,396	\$ 767,946	\$ 660,980
Unallocated expenses.....	(99,724)	(97,293)	(82,909)
Total consolidated operating earnings.....	<u>\$ 782,672</u>	<u>\$ 670,653</u>	<u>\$ 578,071</u>
Assets:			
Total assets for reportable segments	\$2,890,436	\$2,822,449	\$2,548,492
Unallocated assets.....	624,981	271,579	497,596
Total consolidated assets.....	<u>\$3,515,417</u>	<u>\$3,094,028</u>	<u>\$3,046,088</u>

	2008		
	Segment Totals	Unallocated	Consolidated Total
Other significant items:			
Depreciation and amortization	\$ 127,206	\$ 12,364	\$ 139,570
Additions to long-lived assets	\$ 206,481	\$ 7,508	\$ 219,989
		Revenues	Long-Lived Assets
Geographic information:			
United States		\$5,953,205	\$ 998,529
Canada.....		731,131	176,174
Other foreign countries.....		165,696	41,217
		<u>\$6,850,032</u>	<u>\$1,215,920</u>

	2007		
	Segment Totals	Unallocated	Consolidated Total
Other significant items:			
Depreciation and amortization	\$ 119,994	\$ 12,005	\$ 131,999
Additions to long-lived assets	\$ 174,574	\$ 25,558	\$ 200,132
		Revenues	Long-Lived Assets
Geographic information:			
United States		\$5,643,500	\$ 961,624
Canada.....		640,121	206,133
Other foreign countries.....		134,393	20,135
		<u>\$6,418,014</u>	<u>\$1,187,892</u>

	2006		
	Segment Totals	Unallocated	Consolidated Total
Other significant items:			
Depreciation and amortization	\$ 106,357	\$ 12,211	\$ 118,568
Additions to long-lived assets	\$ 158,385	\$ 14,268	\$ 172,653
		Revenues	Long-Lived Assets
Geographic information:			
United States		\$5,197,240	\$ 909,188
Canada		567,626	176,097
Other foreign countries		118,788	8,784
		<u>\$5,883,654</u>	<u>\$1,094,069</u>

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

Revenues are attributed to countries based on the ship-to location of the customer.

Unallocated expenses and unallocated assets primarily relate to the Company headquarters' support services, which are not part of any business segment. Unallocated expenses include payroll and benefits, depreciation and other costs associated with headquarters-related support services. Unallocated assets include non-operating cash and cash equivalents, certain prepaid expenses and property, buildings and equipment – net.

Unallocated assets increased \$353.4 million in the year ended December 31, 2008, when compared with the prior year primarily driven by an increase in non-operating cash and cash equivalents and an increase in deferred tax assets. In 2007, the Company used cash to repurchase shares. In 2008, fewer shares were repurchased, and in addition, a \$500 million term loan was obtained, resulting in higher cash balances.

The change in the carrying amount of goodwill by segment from January 1, 2006 to December 31, 2008, is as follows (in thousands of dollars):

	Acklands – Grainger		Total
	Branch-based	Lab Safety	
Balance at January 1, 2006	\$120,779	\$ 61,947	\$182,726
Acquisitions	—	28,276	28,276
Translation	(331)	—	(331)
Balance at December 31, 2006	120,448	90,223	210,671
Acquisition	—	1,473	1,473
Translation	20,884	—	20,884
Balance at December 31, 2007	141,332	91,696	233,028
Acquisitions	4,381	2,372	6,753
Translation	(26,622)	—	(26,622)
Balance at December 31, 2008	<u>\$119,091</u>	<u>\$ 94,068</u>	<u>\$213,159</u>

NOTE 19 – SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

A summary of selected quarterly information for 2008 and 2007 is as follows (in thousands of dollars, except for per share amounts):

	2008 Quarter Ended				
	March 31	June 30	September 30	December 31	Total
Net sales	\$1,661,046	\$1,756,856	\$1,839,475	\$1,592,655	\$6,850,032
Cost of merchandise sold	981,112	1,050,979	1,097,127	912,592	4,041,810
Gross profit	679,934	705,877	742,348	680,063	2,808,222
Warehousing, marketing and administrative expenses	494,111	521,042	510,891	499,506	2,025,550
Operating earnings	185,823	184,835	231,457	180,557	782,672
Net earnings	114,238	113,179	140,023	107,915	475,355
Earnings per share – basic	1.47	1.48	1.84	1.42	6.21
Earnings per share – diluted	\$ 1.43	\$ 1.43	\$ 1.79	\$ 1.39	\$ 6.04

	2007 Quarter Ended				
	March 31	June 30	September 30	December 31	Total
Net sales	\$1,546,658	\$1,601,011	\$1,658,592	\$1,611,753	\$6,418,014
Cost of merchandise sold	914,570	960,546	999,003	940,272	3,814,391
Gross profit	632,088	640,465	659,589	671,481	2,603,623
Warehousing, marketing and administrative expenses	469,503	473,890	485,257	504,320	1,932,970
Operating earnings	162,585	166,575	174,332	167,161	670,653
Net earnings	101,787	104,791	109,150	104,392	420,120
Earnings per share – basic	1.21	1.25	1.33	1.32	5.10
Earnings per share – diluted	\$ 1.17	\$ 1.21	\$ 1.29	\$ 1.28	\$ 4.94

NOTE 20 – UNCLASSIFIED – NET

The components of Unclassified – net were as follows (in thousands of dollars):

	For the Years Ended December 31,		
	2008	2007	2006
Foreign currency gains – net	\$ 2,404	\$ 54	\$ 31
Income items	242	350	328
Expense items	(295)	(363)	(228)
Unclassified – net	<u>\$ 2,351</u>	<u>\$ 41</u>	<u>\$ 131</u>

NOTE 21 – CONTINGENCIES AND LEGAL MATTERS

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 February 3, 2009, Grainger is named in cases filed on behalf of approximately 2,200 plaintiffs in which there is an allegation of exposure to asbestos and/or silica. Grainger has denied, or intends to deny, the allegations in all of the above-described lawsuits.

In 2008, lawsuits relating to asbestos and/or silica and involving approximately 660 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 has entered agreements with its major insurance carriers relating to the scope, coverage and costs of defense. 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.

Grainger is a party to a contract with the United States General Services Administration (the "GSA") first entered into in 1999 and subsequently extended in 2004. The GSA contract had been the subject of an audit performed by the GSA's Office of the Inspector General. In December 2007, the Company received a letter from the Commercial Litigation Branch of the Civil Division of the Department of Justice (the "DOJ") regarding the GSA contract. The letter suggested that the Company had not complied with its disclosure obligations and the contract's pricing provisions, and had potentially overcharged government customers under the contract.

Discussions relating to the Company's compliance with its disclosure obligations and the contract's pricing provisions are ongoing. The timing and outcome of these discussions are uncertain and could include settlement or civil litigation by the DOJ to recover, among other amounts, treble damages and penalties under the False Claims Act. While this matter is not expected to have a material adverse effect on the Company's financial position, an unfavorable resolution could result in significant payments by the Company. The Company continues to believe that it has complied with the GSA contract in all material respects.

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, including claims relating to product liability, general negligence, environmental issues, employment, intellectual property and other matters. As a government contractor, Grainger is also subject to governmental or regulatory inquiries or audits or other proceedings, including those related to pricing compliance. 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.

NOTE 22 – SUBSEQUENT EVENTS

On February 11, 2009, the Company announced the elimination of 300 to 400 jobs across the Company's work force as a result of lower sales volume and the combination of its Lab Safety Supply and Grainger Industrial Supply businesses. One-time cash severance charges of approximately \$15 million to \$20 million are expected to be recognized between now and the end of the calendar year. Severance payments will be paid out over varying periods.

We consent to the incorporation by reference in the Registration Statements (Form S-8 No.'s 33-43902, 333-24215, 333-61980, 333-105185, 333-124356 and Form S-4 No. 33-32091) of W.W. Grainger, Inc. and in the related prospectuses of our reports dated February 25, 2009, with respect to the consolidated financial statements of W.W. Grainger, Inc. and the effectiveness of internal control over financial reporting of W.W. Grainger, Inc., included in this Annual Report (Form 10-K) for the year ended December 31, 2008.

ERNST & YOUNG LLP

Chicago, Illinois
February 25, 2009

I, J. T. Ryan, certify that:

1. I have reviewed this Annual Report on Form 10-K of W.W. Grainger, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 26, 2009

By: J. T. Ryan

Name: J. T. Ryan

Title: President and Chief Executive Officer

I, R. L. Jadin, certify that:

1. I have reviewed this Annual Report on Form 10-K of W.W. Grainger, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 26, 2009

By: R. L. Jadin

Name: R. L. Jadin

Title: Senior Vice President and Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

EXHIBIT 32(a)

I, J. T. Ryan, President and Chief Executive Officer of W.W. Grainger, Inc. ("Grainger"), certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Annual Report on Form 10-K of Grainger for the annual period ended December 31, 2008, (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Grainger.

J. T. Ryan

J. T. Ryan
President and
Chief Executive Officer

February 26, 2009

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

EXHIBIT 32(b)

I, R. L. Jadin, Senior Vice President and Chief Financial Officer of W.W. Grainger, Inc. ("Grainger"), certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Annual Report on Form 10-K of Grainger for the annual period ended December 31, 2008, (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Grainger.

R. L. Jadin

R. L. Jadin

Senior Vice President
and Chief Financial Officer

February 26, 2009