NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

INDUSTRY INFORMATION

W.W. Grainger, Inc. is a broad-line distributor of maintenance, repair and operating supplies, and other related products and services used by businesses and institutions. 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.

EQUITY METHOD OF ACCOUNTING FOR INVESTMENTS

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 are accounted for as additional contributed capital.

In October 2011, the Company divested its 49% stake in a joint venture, MRO Korea Co., Ltd., for $12 million, resulting in a pretax gain of $8 million ($5 million after-tax) net of the cumulative foreign currency losses reclassified from Accumulated other comprehensive earnings. The Company previously accounted for this investment under the equity method.

USE OF ESTIMATES

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and the disclosure of contingent liabilities. 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 and derivative instruments are recorded as a separate component of other comprehensive earnings. See Note 13 to the Consolidated Financial Statements.

RECLASSIFICATIONS

Certain amounts in the 2011 and 2010 financial statements, as previously reported, have been reclassified to conform to the 2012 presentation. Derivative instruments have been reclassified from the Deferred income taxes, tax uncertainties and derivative instruments line item to Employment-related and other noncurrent liabilities line item on the Consolidated Balance Sheet. This reclassification had no impact on the Consolidated Statement of Earnings or the Consolidated Statement of Cash Flows.

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. eCommerce revenues, which accounted for 30% of total 2012 revenues, are recognized on the same terms as revenues through other channels. Fee revenues, which account for less than 1% of total 2012 revenues, are recognized after services are completed. Taxes collected from customers and remitted to governmental authorities are presented on a net basis and are not included in revenue.

COST OF MERCHANDISE SOLD

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

VENDOR CONSIDERATION

The Company receives rebates and allowances 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, radio 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 advertising expenditure for each vendor, the Company treats most vendor advertising allowances as a reduction to 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 $173 million, $145 million and $123 million for 2012, 2011 and 2010, respectively. Most vendor-provided allowances are classified as an offset to Cost of merchandise sold. For additional information see VENDOR CONSIDERATION above.

Catalog expense is amortized equally over the life of the catalog, beginning in the month of its distribution. Advertising costs for catalogs that have not been distributed by year-end are capitalized as Prepaid expenses. Amounts included in Prepaid expenses at December 31, 2012 and 2011, were $46 million and $50 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 over the vesting period. See Note 11 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. The Company recognizes in the financial statements a provision for tax uncertainties, resulting from application of complex tax regulations in multiple tax jurisdictions. See Note 14 to the Consolidated Financial Statements.

OTHER COMPREHENSIVE EARNINGS (LOSSES)
The Company's Other comprehensive earnings (losses) include foreign currency translation adjustments, changes in fair value of derivatives designated as hedges and unrecognized gains (losses) on postretirement and other employment-related benefit plans. See Note 13 to the Consolidated Financial Statements.

CASH AND CASH EQUIVALENTS
The Company considers investments in highly liquid debt instruments, purchased with an original maturity of 90 days or less, to be cash equivalents.

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, Europe, Asia and Latin America. 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 62% 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 depreciation methods. The principal estimated useful lives for determining depreciation are as follows:

Buildings, structures and improvements	10 to 30 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 million in each of years 2012, 2011 and 2010.

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, are less than the carrying value of the asset. Impairment is measured as the amount by which the carrying amount exceeds the fair value.

The Company recognized impairment charges of $2 million, $8 million and $4 million in 2012, 2011 and 2010, respectively, included in Warehousing, marketing and administrative expenses, to reduce the carrying value of certain long-lived assets to their estimated fair value pursuant to impairment indicators for property currently held for sale, lease terminations, idle assets and branch closures.

CAPITALIZED SOFTWARE

The Company capitalizes certain costs related to the purchase of internal-use 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 $16 million, $19 million and $24 million for the years ended December 31, 2012, 2011 and 2010, respectively. Capitalized software was $72 million and $44 million at December 31, 2012 and 2011, respectively. These costs are included in Other assets and intangibles – net on the Consolidated Balance Sheets.

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 one to 22 years. The straight-line method of amortization is used as it has been determined to approximate customer attrition patterns and the use pattern of the assets. 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. Impairment losses are recognized whenever the implied fair value of these assets is less than their carrying value. See Note 2 and Note 3 to the Consolidated Financial Statements.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying amounts of cash and cash equivalents, receivables, and accounts payable approximate fair value due to the short-term nature of these financial instruments. The carrying value of long-term debt also approximates fair value due to the variable interest rates. The fair value of the Company's qualifying derivative instruments is recorded in the Consolidated Balance Sheets and is discussed in more detail in Note 8 to the Consolidated Financial Statements.

DERIVATIVE INSTRUMENTS AND HEDGING

The Company uses derivative financial instruments to manage exposures to fluctuations in interest rates and foreign currency exchange rates. The Company does not enter into derivative financial instruments for trading or speculative purposes. All derivative instruments are recognized as either assets or liabilities in the balance sheet at their fair value. Changes in the fair value of derivatives are recognized in net earnings or other comprehensive earnings (losses) depending on whether the derivative is designated as part of a qualifying hedging relationship. The ineffective portion of a qualifying hedging derivative and derivatives not designated as a hedge are recognized immediately in earnings. Instruments that do not qualify for hedge accounting are marked to market with the change recognized in current period earnings. See Note 8 and Note 13 to the Consolidated Financial Statements for additional information on the Company's derivative activities.

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. Amounts included in warranty reserves at December 31, 2012 and 2011, were $4 million and $3 million, respectively.

NEW ACCOUNTING STANDARDS

In July 2012, the Financial Accounting Standards Board issued updated guidance on the periodic testing of indefinite-lived assets for impairment. This guidance allows companies to assess qualitative factors to determine if it is more likely than not that an indefinite-lived intangible asset might be impaired. If it is determined that it is more likely than not that the fair value of such an asset exceeds its carrying value, no further testing is necessary. This guidance is applicable for fiscal years beginning after September 15, 2012, with early adoption permitted. The Company early adopted this pronouncement and its adoption did not have a material effect on the consolidated financial statements.

NOTE 2 – BUSINESS ACQUISITIONS

On December 31, 2012, the Company acquired Techni-Tool, Inc. With 2011 sales of $88 million, Techni-Tool is a specialist distributor serving manufacturing customers. The Company paid $40 million for the Techni-Tool, Inc. acquisition, less cash acquired. Goodwill and intangibles recorded totaled approximately $23 million. The purchase price allocation has not been finalized and is subject to change, as the Company obtains additional information during the measurement period related to the valuation of acquired assets and liabilities.

On April 2, 2012, the Company acquired AnFreixo S.A. With 2011 sales of $37 million, AnFreixo, a former subsidiary of the Votorantim Group, is a broad-line distributor of MRO supplies in Brazil. The Company paid $25 million for the AnFreixo acquisition, less cash acquired. Goodwill and intangibles recorded totaled approximately $21 million. The purchase price allocation has not been finalized and is subject to change, as the Company obtains additional information during the measurement period related to the valuation of acquired assets and liabilities, including deferred taxes.

During 2011, the Company acquired Fabory for $358 million, less cash acquired. Goodwill recorded totaled $140 million. Purchased identified intangible assets totaled $131 million. Acquired intangibles primarily consist of customer relationships and trade names. Customer relationships will be amortized on a straight-line basis over 22 years. The indefinite-lived intangible is related to the Fabory trade name and trademarks.

During 2010, the Company acquired four companies and obtained a majority ownership in one joint venture for $62 million, less cash acquired.

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, both individually and in the aggregate, disclosures of amounts assigned to the acquired assets and assumed liabilities and pro forma results of operations were not considered necessary.

NOTE 3 – GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill is recognized as the excess cost of an acquired entity over the 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 changes in the carrying amount of goodwill by segment are as follows (in thousands of dollars):

	United States	Canada	Other Businesses	Total
Balance at January 1, 2011	$151,220	$153,922	$ 82,090	$387,232
Acquisitions	—	171	135,080	135,251
Purchase price adjustments	11	—	—	11
Translation	—	(3,448)	(9,863)	(13,311)
Balance at December 31, 2011	151,231	150,645	207,307	509,183
Acquisitions	23,385	—	12,466	35,851
Purchase price adjustments	—	—	4,523	4,523
Impairment	(4,177)	—	—	(4,177)
Translation	—	4,130	(5,840)	(1,710)
Balance at December 31, 2012	$170,439	$154,775	$218,456	$543,670

The Company tests goodwill and intangible assets with indefinite lives for impairment annually in the fourth quarter and when events or changes in circumstances indicate the carrying value of these assets might exceed their current fair values. The Company tests goodwill for impairment at the reporting unit level. The Company first uses qualitative factors such as current company performance and overall economic factors to determine if it is more likely than not that the goodwill might be impaired and whether it is necessary to perform the two-step quantitative goodwill impairment test. In the two-step test, the Company compares the carrying value of the reporting unit to its fair value. If the carrying value of the reporting unit exceeds its estimated fair value, the second step is performed, where the implied fair value of goodwill is compared to its carrying value, to determine the amount of impairment.

As part of the annual evaluation of goodwill, the Company determined two reporting units required the two-step quantitative test. Based on lower than expected operating performance, the estimated fair value of Grainger Lighting Services (formerly known as Alliance Energy Solutions) decreased. The Company recorded a non-cash impairment charge of $4 million, included in Warehousing, marketing and administrative expenses, reducing the carrying value of goodwill to $13 million for this reporting unit. The estimated fair value of the other reporting unit with goodwill of $125 million exceeded its carrying value and no indication of impairment existed as of the test date.

The fair value estimates used in goodwill impairment analysis required significant judgment and were based on assumptions believed to be reasonable, including business plans, estimates of future revenues and operating margins, and assumptions about the overall economic climate and the competitive environment. There can be no assurance that the Company's estimates and assumptions will prove to be accurate predictions of the future. Changes in management's assumptions and estimates can have a significant impact on the fair value of forecasted cash flows. Due to the inherent uncertainties associated with these unobservable Level 3 inputs, the results of goodwill impairment tests may differ and impairment charges could occur in future periods.

Intangible assets included in Other assets and intangibles – net in the Consolidated Balance Sheets were comprised of the following (in thousands of dollars):

	As of December 31,					
	2012			2011		
	Gross carrying amount	Accumulated amortization	Net carrying amount	Gross carrying amount	Accumulated amortization	Net carrying amount
Amortized customer lists and relationships	$279,068	$124,137	$154,931	$270,460	$114,422	$156,038
Amortized trademarks, trade names and other	34,907	21,885	13,022	35,280	19,914	15,366
Non-amortized trade names	74,782	—	74,782	76,025	—	76,025
Total intangible assets	$388,757	$146,022	$242,735	$381,765	$134,336	$247,429

The estimated useful lives for acquired intangibles are as follows:

Customer lists and relationships	6 to 22 years
Amortized trademarks, trade names and other	5 to 17 years

Amortization expense recognized on intangible assets was $13 million for 2012, $12 million for 2011 and $12 million for 2010, and is included in Warehousing, marketing, and administrative expenses on the Consolidated Statement of Earnings.

Estimated amortization expense for future periods is as follows (in thousands of dollars):

Year	Expense
2013	$ 12,372
2014	12,162
2015	11,913
2016	11,762
2017	11,215
Thereafter	108,529

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,	
	2012	2011
Balance at beginning of period	$18,801	$24,552
Provision for uncollectible accounts	9,504	4,761
Write-off of uncollectible accounts, net of recoveries	(9,100)	(8,138)
Business acquisitions, foreign currency and other	244	(2,374)
Balance at end of period	$19,449	$18,801

NOTE 5 – INVENTORIES

Inventories primarily consist of merchandise purchased for resale. Inventories would have been $376 million and $354 million higher than reported at December 31, 2012 and 2011, respectively, if the FIFO method of inventory accounting had been used for all Company inventories. Net earnings would have increased by $13 million, $11 million and $2 million for the years ended December 31, 2012, 2011 and 2010, respectively, using the FIFO method of accounting. Inventory values using the FIFO method of accounting approximate replacement cost.

The Company provides reserves for excess and obsolete inventory. The reserve balance was $133 million and $125 million as of December 31, 2012 and 2011, respectively. The increase was due to the AnFreixo acquisition and higher reserve requirements in China and India.

NOTE 6 – SHORT-TERM DEBT

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

	As of December 31,	
	2012	2011
Lines of credit	$ 79,071	$ 69,004
Commercial paper	—	50,000
Other short-term borrowings	—	966
	$ 79,071	$119,970

Lines of Credit

The Company had $138 million and $135 million of uncommitted lines of credit denominated in foreign currencies at December 31, 2012 and 2011, respectively. Foreign subsidiaries utilize the lines of credit to meet business growth and operating needs. The maximum month-end balance outstanding during the year was $79 million and $69 million for 2012 and 2011, respectively. The weighted average interest rates were 5.16% and 5.59% during 2012 and 2011, respectively. As of December 31, 2012 and 2011, the weighted average interest rates were 5.07% and 5.37%, respectively.

The Company had a committed line of credit of $400 million in 2012 and 2011 for which the Company paid a commitment fee of 0.10% in 2012 and 2011. This line of credit supports the issuance of commercial paper. The current line is due to expire in July 2014. There were no borrowings under this committed line of credit.

Commercial Paper

During 2011, the Company repaid $150 million of its previously issued $200 million commercial paper and accordingly, the Company reclassified the remaining $50 million from long-term debt to short-term debt as of December 31, 2011. In April 2012, the remaining $50 million commercial paper balance was repaid. The weighted average interest rates paid during 2012 and 2011 were 0.17% and 0.20% and the weighted average interest rate as of December 31, 2011 was 0.14%.

Letters of Credit

The Company had $21 million and $26 million of letters of credit at December 31, 2012 and 2011, respectively, primarily related to the Company's insurance program. Letters of credit were also issued to facilitate the purchase of products. Issued amounts were $4 million at both December 31, 2012 and 2011.

NOTE 7 – LONG-TERM DEBT

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

	As of December 31,	
	2012	2011
Bank term loan	$300,000	$219,932
Euro-denominated bank term loan	158,328	155,340
Other	27,245	21,322
Less current maturities	(18,525)	(221,539)
	$467,048	$175,055

Bank Term Loan

In May 2012, the Company entered into a $300 million, unsecured bank term loan, which matures in November 2016. The proceeds were used to refinance existing debt and for general corporate purposes. The Company may prepay the loan in whole or in part at its option.

At the election of the Company, the term loan shall bear interest at the Base Rate plus the Applicable Margin or the LIBOR Rate plus the Applicable Margin as defined within the term loan agreement. At December 31, 2012, the Company had elected a one month LIBOR Interest Period. The weighted average interest rate during the year was 1.23%.

Euro-Denominated Bank Term Loan

In August 2011, the Company entered into a €120 million, unsecured bank term loan in connection with the acquisition of Fabory, maturing in August 2016. The Company, at its option, may prepay this term loan in whole or in part. Payments of €2.5 million are due semi-annually, beginning February 28, 2013, with the remaining balance due at maturity. The weighted average interest rate paid during the year was 1.80%. The weighted average interest rate includes inputs from variable rates and an interest rate swap. See Note 8 to the Consolidated Financial Statements.

The scheduled aggregate principal payments related to long-term debt are due as follows (in thousands of dollars):

Year	Payment Amount
2013	$ 18,525
2014	27,411
2015	34,725
2016	388,030
2017	1,934
Thereafter	14,948

The Company's debt instruments include only standard affirmative and negative covenants for 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, 2012.

NOTE 8 – DERIVATIVE INSTRUMENTS

The fair value of significant derivative instruments included in Employment-related and other noncurrent liabilities was as follows (in thousands of dollars):

	As of December 31,	
Derivatives Designated as Hedges	2012	2011
Interest rate swap	$4,120	$1,574
Foreign currency forwards	$7,916	$4,781

The fair values of these instruments are determined by using quoted market forward rates (Level 2 inputs) and reflect the present value of the amount that the Company would pay for contracts involving the same notional amounts and maturity dates.

During the fourth quarter of 2011, the Company entered into a pay-fixed/receive floating interest rate swap with a notional value of €60 million maturing in August 2016 to partially hedge the future interest expense of the euro-denominated term loan entered into to fund a portion of the Fabory acquisition. The swap is accounted for as a cash flow hedge. The effective portion of the changes in fair value of the derivative is reported as a component of other comprehensive earnings (losses) and reclassified to net income when the hedged transaction affects earnings.

During the fourth quarter of 2010, the Company entered into multiple foreign currency forward contracts with a total notional value of C$160 million maturing in September 2014. These forward contracts are designated and qualify as a hedge of an intercompany net investment in the Company's Canadian subsidiary. The Company uses the forward method of assessing hedge effectiveness for derivatives designated as hedging instruments of a net investment in a foreign subsidiary and all changes in fair value of the derivatives are reported as a component of other comprehensive earnings (losses), net of tax effects, as long as specific hedge accounting criteria are met.

Other foreign currency forward contracts entered into during the current and prior periods to hedge non-functional currency-denominated intercompany note receivables and forecasted U.S. dollar-denominated obligations by foreign subsidiaries of the Company were not material.

See Note 1 to the Consolidated Financial Statements for a description of the Company's Accounting Policy regarding derivative instruments and Note 13 to the Consolidated Financial Statements for additional information.

NOTE 9 – EMPLOYEE BENEFITS

The Company provides various retirement benefits to eligible employees, including contributions to defined contribution plans, pension benefits associated with defined benefit plans, postretirement medical benefits and other benefits. Eligibility requirements and benefit levels vary depending on employee location. Various foreign benefit plans cover employees in accordance with local legal requirements.

Defined Contribution Plans

A majority of the Company's U.S. employees are covered by a noncontributory profit sharing plan. This plan provides for annual employer contributions based upon a formula related primarily to earnings before federal income taxes, limited to a percentage of the total eligible compensation paid to eligible employees. The annual contribution is limited to a minimum of 8% and a maximum of 18% of total eligible compensation paid to eligible employees. The profit sharing plan expense was $165 million, $156 million and $143 million for 2012, 2011 and 2010, respectively.

The Company sponsors additional defined contribution plans available to certain U.S. and foreign employees for which contributions are paid by the Company and participating employees. The expense associated with these defined contribution plans totaled $12 million, $9 million and $8 million for the years ended December 31, 2012, 2011 and 2010, respectively.

Defined Benefit Plans and Other Retirement Plans

The Company sponsors a defined benefit plan which provides pension benefits for certain employees in the Netherlands. The annual pension benefit is based on 1.75 percent of a career average pay and years of service. The plan is insured and accordingly, all risks with respect to investments, mortality and longevity are covered by an insurance company. The assets of the plan are invested in a separate account with the insurer. A December 31 measurement date is utilized to value plan assets and obligations. Funding of the plan takes place through single premiums for obligations regarding future service years. As of December 31, 2012 and 2011, the pension plan was in an overfunded position with a net pension asset of $6 million and $13 million, respectively. In 2012, the expense related to this plan was not significant to the Company.

In certain countries pension contributions are made to government-sponsored social security pension plans in accordance with local legal requirements. For these plans, the Company has no continuing obligations other than the payment of contributions. The cost of these programs is not significant to the Company.

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. The EDB provides an after-tax lump sum payment of one-time final total compensation to the beneficiary of a participant who dies after retirement. In addition, pre-2008 participants may elect to receive a reduced postretirement payment instead of the EDB. Effective January 1, 2010, the plan is not available to new participants.

The net periodic benefits costs charged to operating expenses were $1 million in each of years 2012, 2011 and 2010. The net loss recognized in Accumulated other comprehensive earnings (AOCE) was $0.2 million and $0.7 million as of December 31, 2012 and 2011, respectively. The net gain recognized in AOCE was $0.4 million as of December 31, 2010. The plan benefits are paid as they come due from the general assets of the Company. The plan benefit obligation was $17 million as of December 31, 2012 and 2011.

Postretirement Benefits

The Company has a postretirement healthcare benefits plan that provides coverage for a majority of its United States employees hired prior to January 1, 2013 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.

During the fourth quarter 2012, the Company implemented plan design changes effective January 1, 2013. Employees hired after January 1, 2013 will not be eligible for retiree health benefits. Active participants in the plan as of December 31, 2012 will remain eligible for retiree health benefits with the employee contribution structure modified for certain employees based on retirement eligibility. As a result of this plan amendment, the Company's postretirement benefit obligation declined $84 million as of December 31, 2012.

During the fourth quarter 2012, the Company also implemented an Employer Group Waiver Plan (EGWP) and a secondary supplemental "wrap-around" plan for its Medicare eligible retiree medical plan participants and will no longer apply for the Part D Retiree Drug Subsidy (RDS) effective January 1, 2013. The EGWP program does not alter the benefits expected to be provided to the plan participants and is expected to increase the level of Medicare subsidies that will offset plan costs. Accordingly, the event is recognized as an actuarial gain for the year ended December 31, 2012. As a result of this change, the Company's postretirement benefit obligation declined $19 million as of December 31, 2012.

The "Medicare Prescription Drug, Improvement and Modernization Act of 2003" 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 Company's accumulated postretirement benefit obligation (APBO) reflected a reduction of $68 million as of December 31, 2011. As a result of the implementation of the EGWP program, the benefit obligation is no longer reduced by Part D RDS as of December 31,2012. The subsidy reduced net periodic benefits costs by approximately $9 million, $7 million and $6 million for the years ended December 31, 2012, 2011 and 2010, 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,		
	2012	2011	2010
Service cost	$20,058	$15,762	$14,293
Interest cost	12,810	13,352	12,852
Expected return on assets	(6,210)	(5,790)	(4,434)
Amortization of prior service credit	(495)	(495)	(495)
Amortization of transition asset	(143)	(143)	(143)
Amortization of unrecognized losses	4,827	3,269	3,649
Net periodic benefits costs	$30,847	$25,955	$25,722

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 of approximately 15.9 years for 2012.

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

	2012	2011
Benefit obligation at beginning of year	$328,912	$257,978
Service cost	20,058	15,762
Interest cost	12,810	13,352
Plan participants' contributions	2,150	2,103
Plan amendments	(84,004)	—
Actuarial (gains) losses	(28,234)	44,883
Benefits paid	(6,047)	(5,551)
Medicare Part D Subsidy received	442	385
Benefit obligation at end of year	246,087	328,912
Plan assets available for benefits at beginning of year	103,519	96,507
Actual returns (losses) on plan assets	13,355	(720)
Employer's contributions	4,962	11,180
Plan participants' contributions	2,150	2,103
Benefits paid	(6,047)	(5,551)
Plan assets available for benefits at end of year	117,939	103,519
Noncurrent postretirement benefit obligation	$128,148	$225,393

The amounts recognized in AOCE consisted of the following components (in thousands of dollars):

	As of December 31,	
	2012	2011
Prior service credit (cost)	$ 81,968	$ (1,542)
Transition asset	286	428
Unrecognized losses	(78,407)	(118,612)
Deferred tax (liability) asset	(1,618)	46,330
Net gains (losses)	$ 2,229	$ (73,396)

The components of AOCE related to the postretirement benefit costs that will be amortized into net periodic postretirement benefit costs in 2013 are estimated as follows (in thousands of dollars):

	2013
Amortization of prior service credit	$ (7,723)
Amortization of transition asset	(143)
Amortization of unrecognized losses	4,931
Estimated amount to be amortized from AOCE into net periodic postretirement benefit costs	$ (2,935)

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, healthcare cost trend rates, cost-sharing 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 following assumptions were used to determine net periodic benefit costs at January 1:

	For the Years Ended December 31,		
	2012	2011	2010
Discount rate	4.50%	5.60%	6.00%
Expected long-term rate of return on plan assets, net of tax	6.00%	6.00%	6.00%
Initial healthcare cost trend rate	8.50%	9.00%	9.50%
Ultimate healthcare cost trend rate	5.00%	5.00%	5.00%
Year ultimate healthcare cost trend rate reached	2019	2019	2019

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

	2012	2011	2010
Discount rate	4.00%	4.50%	5.60%
Expected long-term rate of return on plan assets, net of tax	6.00%	6.00%	6.00%
Initial healthcare cost trend rate	8.00%	8.50%	9.00%
Ultimate healthcare cost trend rate	5.00%	5.00%	5.00%
Year ultimate healthcare cost trend rate reached	2019	2019	2019

The discount rate assumptions reflect the rates available on high-quality fixed income debt instruments as of December 31, the measurement date, of each year. These rates have been selected due to their similarity to the duration of the projected cash flows of the postretirement healthcare benefit plan. As of December 31, 2012, the Company reduced the discount rate from 4.5% to 4.0% to reflect the decrease in the market interest rates which contributed to the increase in the unrealized actuarial loss at December 31, 2012.

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 2012 results (in thousands of dollars):

	1 Percentage Point	
	Increase	(Decrease)
Effect on total service and interest cost	$ 8,909	$ (6,670)
Effect on APBO	35,541	(28,647)

The Company has established a Group Benefit Trust (Trust) to fund the plan obligations and process benefit payments. In December 2010, the Company began to transition the target allocation of the Trust assets from 100% U.S. equities to 50% U.S. equities and 50% non-U.S. equities. This investment strategy reflects the long-term nature of the plan obligation and seeks to take advantage of the earnings potential of equity securities in the global markets. The assets of the Trust are invested in funds designed to track to either the Standard & Poor's 500 Index (S&P 500) or the Total International Composite Index. The Total International Composite Index tracks non-U.S. stocks within developed and emerging market economies. The plan's assets are stated at fair value which represents the net asset value of shares held by the plan in the registered investment companies at the quoted market prices (Level 1 input) as of December 31 (in thousands of dollars):

	2012	2011
Registered investment companies		
Fidelity Spartan U.S. Equity Index Fund	$ 51,169	$ 44,138
Vanguard 500 Index Fund	51,336	44,265
Vanguard Total International Stock	21,739	18,379
Total Assets	$124,244	$106,782

The Company uses the long-term historical return on the plan assets and the historical performance of the S&P 500 and, beginning in 2010, the Total International Composite Index 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 recognition of 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 Company's investment policies include periodic reviews by management and trustees at least annually concerning: (1) the allocation of assets among various asset classes (e.g., domestic stocks, international stocks, short-term bonds, long-term bonds, etc.); (2) the investment performance of the assets, including performance comparisons with appropriate benchmarks; (3) investment guidelines and other matters of investment policy; and (4) the hiring, dismissal, or retention of investment managers.

The funding of the trust is an estimated amount that is intended to allow the maximum deductible contribution under the Internal Revenue Code of 1986 (IRC), as amended, and was $7 million and $17 million for the years ended December 31, 2011 and 2010, respectively. There was no additional funding of the trust for the year ended December 31, 2012. 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) for the next ten years (in thousands of dollars):

Year	Estimated Gross Benefit Payments
2013	$ 4,959
2014	5,714
2015	6,553
2016	7,530
2017	8,660
2018 – 2022	61,393

NOTE 10 – LEASES

The Company leases certain land, buildings and equipment under noncancellable operating leases that expire at various dates through 2036. Capital leases as of December 31, 2012 are not considered material. 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, 2012, the approximate future minimum lease payments for all operating leases were as follows (in thousands of dollars):

Year	Future Minimum Lease Payments
2013	$ 54,456
2014	47,913
2015	39,641
2016	30,088
2017	20,433
Thereafter	39,156
Total minimum payments required	231,687
Less amounts representing sublease income	(1,803)
	$229,884

Rent expense, including items under lease and items rented on a month-to-month basis, was $68 million, $72 million and $53 million for 2012, 2011 and 2010, respectively. These amounts are net of sublease income of $1 million, $2 million and $1 million for 2012, 2011 and 2010, respectively.

NOTE 11 – STOCK INCENTIVE PLANS

The Company maintains stock incentive plans under which the Company may grant a variety of incentive awards to employees and directors. In 2010, the Company's shareholders approved the 2010 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. A total of 5.9 million shares of common stock have been reserved for issuance under the Plan. As of December 31, 2012, there were 2.5 million shares available for grant under the Plan. Non-qualified stock options, performance shares, restricted stock units and deferred stock units have been granted and are outstanding under these plans.

Pretax stock-based compensation expense was $53 million, $51 million, and $47 million in 2012, 2011 and 2010, respectively. Related income tax benefits recognized in earnings were $18 million in each of the years 2012 and 2011 and $17 million in 2010.

Options

In 2012, 2011 and 2010, the Company issued stock option grants to employees as part of their incentive compensation. In 2010, the Company also provided broad-based stock option grants covering 256,000 shares to those employees who reached major service milestones and were not participants in other stock option programs.

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, 2010	5,474,596	$ 68.07	3,141,996
Granted	945,450	$106.70	
Exercised	(1,444,898)	$ 64.39	
Canceled or expired	(93,900)	$ 84.02	
Outstanding at December 31, 2010	4,881,248	$ 77.61	2,486,478
Granted	520,327	$149.15	
Exercised	(1,323,883)	$ 63.08	
Canceled or expired	(117,017)	$ 89.18	
Outstanding at December 31, 2011	3,960,675	$ 91.53	1,808,667
Granted	404,111	$203.96	
Exercised	(972,015)	$ 74.14	
Canceled or expired	(34,055)	$105.36	
Outstanding at December 31, 2012	3,358,716	$109.95	1,629,468

At December 31, 2012, there was $14 million of total unrecognized compensation expense related to nonvested option awards, which the Company expects to recognize over a weighted average period of 1.8 years.

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

	For the Years Ended December 31,		
	2012	2011	2010
Fair value of options exercised	$ 18,120	$ 20,933	$ 22,665
Total intrinsic value of options exercised	126,138	124,441	75,204
Fair value of options vested	15,551	13,549	17,974
Settlements of options exercised	72,066	83,504	87,024

Information about stock options outstanding and exercisable as of December 31, 2012, is as follows:

	Options Outstanding				Options Exercisable			
		Weighted Average				Weighted Average		
Range of Exercise Prices	Number	Remaining Contractual Life	Exercise Price	Intrinsic Value (000's)	Number	Remaining Contractual Life	Exercise Price	Intrinsic Value (000's)
$45.50 – $ 78.86	714,047	2.92 years	$ 65.56	$ 97,688	714,047	2.92 years	$ 65.56	$ 97,688
$81.49 – $ 85.82	875,035	5.70 years	$ 83.23	104,251	875,035	5.70 years	$ 83.23	104,251
$91.61 – $108.15	848,250	7.25 years	$106.53	81,282	36,550	6.97 years	$105.20	3,552
$110.54 – $204.24	921,384	8.75 years	$172.86	27,187	3,836	8.53 years	$160.89	159
	3,358,716	6.34 years	$109.95	$310,408	1,629,468	4.52 years	$ 76.16	$205,650

The Company uses a binomial lattice option pricing model for the valuation of stock options. The weighted average fair value of options granted in 2012, 2011 and 2010 was $43.98, $33.95 and $24.53, respectively. The fair value of each option granted in 2012, 2011 and 2010 used the following assumptions:

	For the Years Ended December 31,		
	2012	2011	2010
Risk-free interest rate	1.1%	2.6%	2.9%
Expected life	6 years	6 years	6 years
Expected volatility	25.9%	24.6%	24.7%
Expected dividend yield	1.6%	1.8%	2.0%

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 Company's closing stock price 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

The Company awards 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 is granted a base number of shares. At the end of the performance period, the number of shares granted will be increased, decreased or remain the same based upon actual Company-wide sales versus target sales. The shares, as determined at the end of the performance period, are 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 ratable basis over the three-year period based on the number of shares expected to vest. Holders of performance share awards are not entitled to receive cash payments equivalent to cash dividends. If the performance shares vest, they will be settled by the Company's issuance of 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:

	2012		2011		2010	
	Shares	Weighted Average Price Per Share	Shares	Weighted Average Price Per Share	Shares	Weighted Average Price Per Share
Beginning nonvested shares outstanding	192,740	$109.16	177,120	$ 84.74	72,362	$80.01
Issued	28,639	$177.75	96,236	$127.43	140,400	$87.29
Cancelled	(1,666)	$114.41	(13,056)	$ 87.24	(1,069)	$86.00
Vested	(101,734)	$ 90.47	(67,560)	$ 72.86	(34,573)	$86.00
Ending nonvested shares outstanding	117,979	$141.86	192,740	$109.16	177,120	$84.74

At December 31, 2012, there was $7 million of total unrecognized compensation expense related to performance-based share awards that the Company expects to recognize over a weighted average period of 1.5 years.

Restricted Stock Units (RSUs)

RSUs granted vest over periods from three to seven years from issuance, although accelerated vesting is provided in certain instances. Holders of RSUs are entitled to receive cash payments equivalent to cash dividends and other distributions paid with respect to common stock. RSUs are settled by the issuance of the Company's common stock on a one-for-one basis. Compensation expense related to RSUs is based upon the closing market price 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:

	2012		2011		2010	
	Shares	Weighted Average Price Per Share	Shares	Weighted Average Price Per Share	Shares	Weighted Average Price Per Share
Beginning nonvested units	1,119,488	$100.76	1,205,787	$ 88.65	1,241,364	$ 80.96
Issued	152,995	$204.26	242,212	$152.55	274,740	$109.63
Cancelled	(37,972)	$123.01	(92,202)	$ 89.57	(61,745)	$ 82.59
Vested	(255,623)	$ 88.36	(236,309)	$ 86.13	(248,572)	$ 77.37
Ending nonvested units	978,888	$118.60	1,119,488	$100.76	1,205,787	$ 88.65
Fair value of shares vested (in millions)	$23		$20		$19	

At December 31, 2012, there was $54 million of total unrecognized compensation expense related to nonvested RSUs that the Company expects to recognize over a weighted average period of 3 years.

Director Stock Awards

The Company's Board of Directors receive both cash and deferred stock units (DSUs) for its services. A deferred stock unit is the economic equivalent of a share of common stock. The directors were each awarded $115,000 of deferred stock units in 2012 and 2011, and $100,000 in 2010. The number of units granted was based on the 200-day average stock price as of January 31 of the grant year. Compensation expense related to the DSUs is based upon the closing market price on the last trading day. DSUs vest immediately at grant and are entitled to receive dividends and other distributions with respect to common stock, which are deferred as stock units, based on the market value of the stock at relevant times. Directors can also elect to defer their cash fees in the form of deferred stock units. Settlement of DSUs is required to be deferred until after termination of service as a director. Effective April 2012, the Board approved a change in the settlement procedure to eliminate the cash settlement option and the directors agreed to settle their outstanding DSUs in shares. As of December 31, 2012, 2011 and 2010, there were eleven nonemployee directors and one former nonemployee director who held DSUs. The accumulated value of DSUs of $31 million is recorded in Additional paid in capital at December 31, 2012. The outstanding DSUs were recorded as a liability of $27 million and $18 million in Employment-related and other noncurrent liabilities at December 31, 2011 and 2010, respectively. The following table summarizes DSUs activity (dollars in thousands):

	2012		2011		2010	
	Units	Dollars	Units	Dollars	Units	Dollars
Beginning balance	142,797	$ 26,730	130,377	$ 18,006	113,509	$ 10,991
Dividends	2,273	454	2,244	350	2,416	261
Deferred fees	9,170	1,871	12,601	1,878	14,452	1,563
Retirement distribution	(2,465)	(461)	(2,425)	(335)	—	—
Unit appreciation	—	2,358	—	6,831	—	5,191
Ending balance	151,775	$ 30,952	142,797	$ 26,730	130,377	$ 18,006

NOTE 12 – CAPITAL STOCK

The Company had no shares of preferred stock outstanding as of December 31, 2012 and 2011. The activity related to outstanding common stock and common stock held in treasury was as follows:

	2012		2011	
	Outstanding Common Stock	Treasury Stock	Outstanding Common Stock	Treasury Stock
Balance at beginning of period	69,962,852	39,696,367	69,377,802	40,281,417
Exercise of stock options, net of 5,310, and 0 shares swapped in stock-for-stock exchange, respectively	966,705	(966,705)	1,323,883	(1,323,883)
Settlement of restricted stock units, net of 121,353 and 141,467 shares retained, respectively	225,997	(225,997)	257,931	(257,931)
Settlement of performance share units, net of 23,590 and 11,731 shares retained, respectively	44,051	(44,051)	22,842	(22,842)
Purchase of treasury shares	(1,721,110)	1,721,110	(1,019,606)	1,019,606
Balance at end of period	69,478,495	40,180,724	69,962,852	39,696,367

NOTE 13 – 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,	
	2012	2011
Foreign currency translation adjustments	$ 85,231	$ 76,234
Derivative instruments	(11,965)	(6,286)
Postretirement benefit plan	3,847	(119,726)
Other employment-related benefit plans	(9,835)	(3,170)
Deferred tax (liability) asset	(11,184)	35,592
Total accumulated other comprehensive earnings (losses)	56,094	(17,356)
Less: Foreign currency translation adjustments attributable to noncontrolling interest	2,516	11,382
Total accumulated other comprehensive earnings (losses) attributable to W.W. Grainger, Inc.	$ 53,578	$ (28,738)

The change in comprehensive earnings (losses) on Postretirement benefit plan was primarily due to changes made to the plan, partially offset by a decrease in the discount rate. See Note 9 to the Consolidated Financial Statements.

NOTE 14 – 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,		
	2012	2011	2010
Current provision:			
Federal	$324,848	$275,489	$283,481
State	40,508	49,098	48,241
Foreign	53,564	45,405	21,235
Total current	418,920	369,992	352,957
Deferred tax provision (benefit)	20	15,123	(12,761)
Total provision	$418,940	$385,115	$340,196

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

	For the Years Ended December 31,		
	2012	2011	2010
United States	$ 982,220	$ 917,820	$802,135
Foreign	135,569	133,707	51,643
	$1,117,789	$1,051,527	$853,778

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,	
	2012	2011
Deferred tax assets:		
Inventory	$ 30,991	$ 26,845
Accrued expenses	26,706	30,411
Accrued employment-related benefits	139,931	170,514
Foreign operating loss carryforwards	67,148	58,813
Other	31,008	23,870
Deferred tax assets	295,784	310,453
Less valuation allowance	(54,434)	(53,739)
Deferred tax assets, net of valuation allowance	$ 241,350	$ 256,714
Deferred tax liabilities:		
Property, buildings and equipment	(37,876)	(22,498)
Intangibles	(114,955)	(112,569)
Software	(16,653)	(10,194)
Prepaids	(20,509)	(20,038)
Other	(19,291)	(16,893)
Deferred tax liabilities	(209,284)	(184,192)
Net deferred tax asset	$ 32,066	$ 72,522
The net deferred tax asset is classified as follows:		
Current assets	$ 55,967	$ 47,410
Noncurrent assets	51,536	100,830
Noncurrent liabilities (foreign)	(75,437)	(75,718)
Net deferred tax asset	$ 32,066	$ 72,522

At December 31, 2012, the Company had $253 million of operating loss carryforwards related primarily to foreign operations. Some of the operating loss carryforwards may expire at various dates through 2022. 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,	
	2012	2011
Beginning balance	$ 53,739	$ 20,087
Increase related to foreign net operating loss carryforwards	695	33,652
Ending balance	$ 54,434	$ 53,739

The increase in the valuation allowance for foreign net operating loss carryforwards at December 31, 2011, relates primarily to the acquisition of Fabory. See Note 2 to the Consolidated Financial Statements.

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,		
	2012	2011	2010
Federal income tax at the 35% statutory rate	$391,226	$368,034	$298,822
State income taxes, net of federal income tax benefit	26,099	32,226	30,457
Other – net	1,615	(15,145)	10,917
Income tax expense	$418,940	$385,115	$340,196
Effective tax rate	37.5%	36.6%	39.8%

In 2011, other – net included the tax benefit related to settlement of various tax reviews during 2011 and the benefit of tax law changes in Japan enacted in the fourth quarter of 2011. In 2010, other – net included an expense related to the U.S. healthcare legislation.

Undistributed earnings of foreign subsidiaries at December 31, 2012, amounted to $326 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 its foreign operations.

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

	2012	2011
Balance at beginning of year	$22,760	$34,060
Additions to tax positions related to the current year	11,369	8,067
Additions for tax positions of prior years	8,977	2,175
Reductions for tax positions of prior years	(1,447)	(8,087)
Reductions due to statute lapse	(737)	(696)
Settlements, audit payments, refunds – net	15	(12,759)
Balance at end of year	$40,937	$22,760

The Company classifies the liability for tax uncertainties in Deferred income taxes and tax uncertainties. Included in this amount are $6 million and $3 million at December 31, 2012 and 2011, 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 increase in the additions to tax positions of prior years in 2012 related primarily to acquisitions.

The Company regularly undergoes examination of its federal income tax returns by the Internal Revenue Service (IRS). During 2011, the Company concluded the review of its 2007 and 2008 federal income tax returns with the IRS. The Company's federal tax returns for 2009 and 2010 are currently under audit by the IRS, and the tax years 2011 and 2012 are open. The Company is also subject to audit by state, local and foreign taxing authorities. Tax years 2002 - 2012 remain subject to state and local audits and 2005 - 2012 remain subject to foreign audits. The estimated amount of liability associated with the Company's uncertain tax positions may change within the next twelve months due to the pending audit activity, expiring statutes or tax payments.

The Company recognizes interest expense in the provision for income taxes. During 2012 and 2010, the Company recognized an expense of $1 million for each year. During 2011, the Company recognized a net benefit of $1 million, primarily due to settlement of audits and a statute lapse. As of December 31, 2012 and 2011, the Company accrued approximately $2 million and $1 million, respectively, for interest.

NOTE 15 – EARNINGS PER SHARE

The Company's unvested Restricted Stock Units and Directors' Deferred Stock Units that contain nonforfeitable rights to dividends meet the criteria of a participating security. Under the two-class method, earnings are allocated between common stock and participating securities. The presentation of basic and diluted earnings per share is required only for each class of common stock and not for participating securities. As such, the Company presents basic and diluted earnings per share for its one class of common stock.

The two-class method includes an earnings allocation formula that determines earnings per share for each class of common stock according to dividends declared and undistributed earnings for the period. The Company's reported net earnings is reduced by the amount allocated to participating securities to arrive at the earnings allocated to common stock shareholders for purposes of calculating earnings per share.

The dilutive effect of participating securities is calculated using the more dilutive of the treasury stock or the two-class method. The Company has determined the two-class method to be the more dilutive. As such, the earnings allocated to common stock shareholders in the basic earnings per share calculation is adjusted for the reallocation of undistributed earnings to participating securities to arrive at the earnings allocated to common stock shareholders for calculating the diluted earnings per share.

The following table sets forth the computation of basic and diluted earnings per share under the two-class method (in thousands of dollars, except for share and per share amounts:

	For the Years Ended December 31,		
	2012	2011	2010
Net earnings attributable to W.W. Grainger, Inc. as reported	$689,881	$658,423	$510,865
Distributed earnings available to participating securities	(3,641)	(3,216)	(3,086)
Undistributed earnings available to participating securities	(8,704)	(9,635)	(8,355)
Numerator for basic earnings per share – Undistributed and distributed earnings available to common shareholders	677,536	645,572	499,424
Undistributed earnings allocated to participating securities	8,704	9,635	8,355
Undistributed earnings reallocated to participating securities	(8,540)	(9,438)	(8,208)
Numerator for diluted earnings per share – Undistributed and distributed earnings available to common shareholders	$677,700	$645,769	$499,571
Denominator for basic earnings per share – weighted average shares	69,811,881	69,690,854	70,836,945
Effect of dilutive securities	1,369,852	1,485,304	1,301,913
Denominator for diluted earnings per share – weighted average shares adjusted for dilutive securities	71,181,733	71,176,158	72,138,858
Earnings per share two-class method			
Basic	$ 9.71	$ 9.26	$ 7.05
Diluted	$ 9.52	$ 9.07	$ 6.93

NOTE 16 – SEGMENT INFORMATION

The Company has two reportable segments: the United States and Canada. The United States operating segment reflects the results of the Company's U.S. business. The Canada operating segment reflects the results for Acklands – Grainger Inc., the Company's Canadian business. Other businesses include the Company's operations in Europe, Asia, Latin America and other U.S. operations. These businesses individually do not meet the criteria of a reportable segment. Operating segments generate revenue almost exclusively through the distribution of maintenance, repair and operating supplies, as service revenues account for less than 1% of total revenues for each operating segment.

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 segment results include certain centrally incurred costs for shared services that are charged to the segments based upon the relative level of service used by each operating segment.

Following is a summary of segment results (in thousands of dollars):

	2012			
	United States	Canada	Other Businesses	Total
Total net sales	$6,925,842	$1,105,782	$1,006,762	$9,038,386
Intersegment net sales	(87,249)	(363)	(729)	(88,341)
Net sales to external customers	6,838,593	1,105,419	1,006,033	8,950,045
Segment operating earnings	1,132,722	127,412	20,289	1,280,423
Segment assets	1,884,102	387,915	347,905	2,619,922
Depreciation and amortization	99,229	14,058	19,202	132,489
Additions to long-lived assets	$ 182,985	$ 46,330	$ 21,611	$ 250,926

	2011			
	United States	Canada	Other Businesses	Total
Total net sales	$6,501,343	$992,823	$647,666	$8,141,832
Intersegment net sales	(62,766)	(163)	(718)	(63,647)
Net sales to external customers	6,438,577	992,660	646,948	8,078,185
Segment operating earnings	1,066,324	107,582	30,984	1,204,890
Segment assets	1,845,703	335,900	331,892	2,513,499
Depreciation and amortization	100,017	12,840	11,035	123,892
Additions to long-lived assets	$ 148,803	$ 29,744	$ 13,402	$ 191,949

	2010			
	United States	Canada	Other Businesses	Total
Total net sales	$6,020,069	$820,941	$389,621	$7,230,631
Intersegment net sales	(47,913)	(137)	(423)	(48,473)
Net sales to external customers	5,972,156	820,804	389,198	7,182,158
Segment operating earnings	920,222	46,836	11,661	978,719
Segment assets	1,629,208	313,133	151,348	2,093,689
Depreciation and amortization	105,478	12,407	7,809	125,694
Additions to long-lived assets	$ 100,194	$ 20,745	$ 5,660	$ 126,599

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

	2012	2011	2010
Operating earnings:			
Total operating earnings for reportable segments	$1,280,423	$1,204,890	$ 978,719
Unallocated expenses	(149,298)	(152,461)	(118,244)
Total consolidated operating earnings	$1,131,125	$1,052,429	$ 860,475
Assets:			
Assets for reportable segments	$2,619,922	$2,513,499	$2,093,689
Other current and noncurrent assets	1,967,480	1,749,029	1,323,082
Unallocated assets	427,196	453,534	487,606
Total consolidated assets	$5,014,598	$4,716,062	$3,904,377

	2012		
	Segment Totals	Unallocated	Consolidated Total
Other significant items:			
Depreciation and amortization	$ 132,489	$ 13,123	$ 145,612
Additions to long-lived assets	$ 250,926	$ 6,998	$ 257,924

	Revenues	Long-Lived Assets
Geographic information:		
United States	$6,786,361	$ 944,400
Canada	1,120,470	136,644
Other foreign countries	1,043,214	135,438
	$8,950,045	$1,216,482

	2011		
	Segment Totals	Unallocated	Consolidated Total
Other significant items:			
Depreciation and amortization	$ 123,892	$ 13,319	$ 137,211
Additions to long-lived assets	$ 191,949	$ 5,665	$ 197,614

	Revenues	Long-Lived Assets
Geographic information:		
United States	$6,388,506	$ 872,947
Canada	998,014	102,085
Other foreign countries	691,665	129,014
	$8,078,185	$1,104,046

	2010		
	Segment Totals	Unallocated	Consolidated Total
Other significant items:			
Depreciation and amortization	$ 125,694	$ 12,099	$ 137,793
Additions to long-lived assets	$ 126,599	$ 4,941	$ 131,540

	Revenues	Long-Lived Assets
Geographic information:		
United States	$5,922,668	$ 845,008
Canada	823,220	87,325
Other foreign countries	436,270	64,900
	$7,182,158	$ 997,233

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, as well as intercompany eliminations. 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.

Assets for reportable segments include net accounts receivable and first-in, first-out inventory which are reported to the Company's Chief Operating Decision Maker. Long-lived assets consist of property, buildings, equipment and capitalized software.

Depreciation and amortization presented above includes depreciation of long-lived assets and amortization of capitalized software.

NOTE 17 – SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

A summary of selected quarterly information for 2012 and 2011 is as follows (in thousands of dollars, except for per share amounts):

	2012 Quarter Ended				
	March 31	June 30	September 30	December 31	Total
Net sales	$2,193,445	$2,249,275	$2,281,205	$2,226,120	$8,950,045
Cost of merchandise sold	1,219,113	1,270,932	1,287,245	1,256,595	5,033,885
Gross profit	974,332	978,343	993,960	969,525	3,916,160
Warehousing, marketing and administrative expenses	669,971	664,343	739,634	711,087	2,785,035
Operating earnings	304,361	314,000	254,326	258,438	1,131,125
Net earnings attributable to W.W. Grainger, Inc.	187,516	190,704	155,394	156,267	689,881
Earnings per share – basic	2.63	2.68	2.19	2.21	9.71
Earnings per share – diluted (1)	$ 2.57	$ 2.63	$ 2.15	$ 2.17	$ 9.52

	2011 Quarter Ended				
	March 31	June 30	September 30	December 31	Total
Net sales	$1,883,612	$2,003,022	$2,114,647	$2,076,904	$8,078,185
Cost of merchandise sold	1,053,998	1,140,628	1,201,648	1,171,119	4,567,393
Gross profit	829,614	862,394	912,999	905,785	3,510,792
Warehousing, marketing and administrative expenses	567,000	597,112	609,959	684,292	2,458,363
Operating earnings	262,614	265,282	303,040	221,493	1,052,429
Net earnings attributable to W.W. Grainger, Inc.	157,933	169,885	182,121	148,484	658,423
Earnings per share – basic	2.23	2.39	2.56	2.08	9.26
Earnings per share – diluted	$ 2.18	$ 2.34	$ 2.51	$ 2.04	$ 9.07

(1) The third quarter of 2012 included a $0.66 per share expense related to the settlement of disputes involving the GSA and USPS contracts.

NOTE 18 – CONTINGENCIES AND LEGAL MATTERS

The Company has been named, along with numerous other nonaffiliated companies, as a defendant in litigation in various states involving asbestos and/or silica. These lawsuits typically assert claims of personal injury arising from alleged exposure to asbestos and/or silica as a consequence of products purportedly distributed by the Company. In 2012, the Company was named in lawsuits relating to asbestos involving approximately 130 new plaintiffs, and lawsuits relating to asbestos and/or silica involving approximately 46 plaintiffs were dismissed with respect to the Company, typically based on the lack of product identification.

As of January 25, 2013, the Company is named in cases filed on behalf of approximately 1,925 plaintiffs in which there is an allegation of exposure to asbestos and/or silica. The Company has denied, or intends to deny, the allegations in all of the above-described lawsuits. If a specific product distributed by the Company is identified in any of these lawsuits, the Company would attempt to exercise indemnification remedies against the product manufacturer. In addition, the Company believes that a substantial number of these claims are covered by insurance. The Company has entered into agreements with its major insurance carriers relating to the scope, coverage and costs of defense of lawsuits involving claims of exposure to asbestos. While the Company is unable to predict the outcome of these lawsuits, it believes that the ultimate resolution will not have, either individually or in the aggregate, a material adverse effect on the Company's consolidated financial position or results of operations.

On December 26, 2012, the Company announced that it entered into a definitive settlement agreement (the "Agreement") with the United States of America, acting through the Civil Division of the United States Department of Justice (DOJ). The Agreement relates to previously disclosed discussions with the DOJ regarding the Company's compliance with its disclosure obligations and the pricing provisions of the Company's contracts with the General Services Administration and the United States Postal Service. Pursuant to the Agreement, the Company paid the United States $70 million plus interest from September 20, 2012. In consideration of this payment, the United States released the Company with respect to claims alleged by the DOJ. The Agreement does not contain any admission of wrongdoing by the Company. As previously disclosed, the Company recorded a $76 million liability for this matter for the quarter ended September 30, 2012. This amount included an estimate for liabilities associated with alleged claims for tax, freight and billing errors that were not covered by the Agreement.

From time to time the Company is involved in various other legal and administrative proceedings that are incidental to its business, including claims relating to product liability, premises liability, general negligence, environmental issues, employment, intellectual property and other matters. As a government contractor selling to federal, state and local governmental entities, the Company 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 the Company's consolidated financial position or results of operations.

SIGNATURES

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

DATE: February 27, 2013

W.W. GRAINGER, INC.

By: James T. Ryan

James T. Ryan
Chairman, President and
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of Grainger on February 27, 2013, in the capacities indicated.

James T. Ryan

James T. Ryan
Chairman, President and
Chief Executive Officer
(Principal Executive Officer and Director)

Ronald L. Jadin

Ronald L. Jadin
Senior Vice President
and Chief Financial Officer
(Principal Financial Officer)

Gregory S. Irving

Gregory S. Irving
Vice President and Controller
(Principal Accounting Officer)

Brian P. Anderson

Brian P. Anderson
Director

Wilbur H. Gantz

Wilbur H. Gantz
Director

V. Ann Hailey

V. Ann Hailey
Director

William K. Hall

William K. Hall
Director

Stuart L. Levenick

Stuart L. Levenick
Director

John W. McCarter, Jr.

John W. McCarter, Jr.
Director

Neil S. Novich

Neil S. Novich
Director

Michael J. Roberts

Michael J. Roberts
Director

Gary L. Rogers

Gary L. Rogers
Director

E. Scott Santi

E. Scott Santi
Director

James D. Slavik

James D. Slavik
Director

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the Registration Statement (Form S-8 No.'s 33-43902, 333-24215, 333-61980, 333-105185, 333-124356, 333-166345 and Form S-4 No. 33-32091) for W.W. Grainger, Inc. and in the related prospectuses of our reports dated February 27, 2013, 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, 2012.

ERNST & YOUNG LLP

Chicago, Illinois

February 27, 2013

CERTIFICATION

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 27, 2013

By: J. T. Ryan

Name: J. T. Ryan

Title: Chairman, President and Chief Executive Officer

CERTIFICATION

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 27, 2013

By: R. L. Jadin

Name: R. L. Jadin

Title: Senior Vice President and Chief Financial Officer

EXHIBIT 32

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

In connection with the Annual Report on Form 10-K of W.W. Grainger, Inc. (“Grainger”) for the annual period ended December 31, 2012, (the “Report”), J. T. Ryan, as Chairman, President and Chief Executive Officer of Grainger, and R. L. Jadin, as Senior Vice President and Chief Financial Officer of Grainger, each hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. 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

Chairman, President and
Chief Executive Officer

February 27, 2013

R. L. Jadin

R. L. Jadin

Senior Vice President
and Chief Financial Officer

February 27, 2013