GRAINGER W W INC
Form 10-K405
March 20, 2002

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K
ANNUAL REPORT

(Mark One)
[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2001
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number 1-5684

W.W. Grainger, Inc.

(Exact name of registrant as specified in its charter)

Illinois	36-1150280
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

100 Grainger Parkway, Lake Forest, Illinois 60045-5201
(Address of principal executive offices) (Zip Code)
Registrant's telephone number including area code: 847/535-1000

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

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

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

Yes_X_ No__

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

The aggregate market value of the voting stock held by non-affiliates of the registrant was $4,611,782,578 as of the close of trading reported on the Consolidated Transaction Reporting System on March 4, 2002.

APPLICABLE ONLY TO CORPORATE REGISTRANTS

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Common Stock $0.50 par value	93,551,269 shares outstanding as of March 4, 2002

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the proxy statement relating to the annual meeting of shareholders of the registrant to be held on April 24, 2002, are incorporated by reference into Part III hereof.

The Exhibit Index appears on page 15 in the sequential numbering system.

(The Securities and Exchange Commission has not approved or disapproved of this report nor has it passed on the accuracy or adequacy hereof.)

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FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA...

PART I

Item 1: Business

The Company

The registrant, W.W. Grainger, Inc., was incorporated in the State of Illinois in 1928. It is the leading North American distributor of products used by businesses and institutions to maintain, repair, and operate their facilities. W.W. Grainger, Inc. regards itself as being in the service business. As used herein, "Company" means W.W. Grainger, Inc. and/or its subsidiaries as the context may require.

The Company offers a breadth of maintenance, repair, and operating (MRO) solutions by combining products, services, and information. It tailors its capabilities with a view toward providing the lowest total cost MRO solution to select customer groups. The Branch-based Distribution Businesses primarily serve the needs of North American businesses for MRO supplies. Lab Safety Supply serves customers who choose to purchase safety and other industrial products through a direct marketing company. The Other Businesses of the Company serve customers who seek to outsource their MRO supply procurement and management processes.

The Company also has internal business support functions which provide coordination and guidance in the areas of Accounting, Administrative Services, Business Development, Communications, Compensation and Benefits, Employee Development, Enterprise Systems, Finance, Human Resources, Industrial Relations, Investor Relations, Insurance and Risk Management, Internal Audit, International Operations, Legal, Real Estate and Construction Services, Security and Safety, Taxes, and Treasury services. These services are provided in varying degrees to all of the business units.

A number of Company-wide capabilities assist business units in serving their respective markets. These capabilities include technology and information management, supplier partnerships, supply chain management skills, and an understanding of the customers MRO environments.

The Company does not engage in basic or substantive product research and development activities. New items are added regularly to the Company s product lines on the basis of market information, recommendations of its employees, customers, and suppliers, and other factors. The Company s research and development efforts are focused on methods of serving customers and the product distribution process.

In January 2001, the Company announced it had consolidated three of its digital businesses into a separate organization. TotalMRO.com, FindMRO, and MROverstocks.com were combined to create Material Logic, which was designed to allow large customers to access a single, networked catalog. Material Logic sought funding participation from other industrial distributors and investors. Economic and market conditions made it difficult to find funding partners and in April 2001, the Company announced it was discontinuing the operations of Material Logic. All of Material Logic s branded e-commerce sites were shut down with the exception of FindMRO, which remains as an integrated sourcing service for the Company s customers.

Branch-based Distribution Businesses

The Company's Branch-based Distribution Businesses provide customers with solutions to their immediate and/or planned MRO purchase needs throughout North America. Logistics networks are configured for rapid availability. A broad selection of MRO products is offered at local branches, through catalogs, and via the Internet. The Branch-based Distribution Businesses consist of Grainger Industrial Supply, Grainger.com, Acklands-Grainger Inc. (Canada), FindMRO, Grainger Export, Grainger Global Sourcing, Grainger Parts, Grainger, S.A. de C.V. (Mexico), and Grainger Caribe Inc. (Puerto Rico). Described below are the more significant of these businesses.

Grainger Industrial Supply

The focus of Grainger Industrial Supply is to provide the best combination of product selection, local availability, speed of delivery, and simplicity of ordering at a competitive price to United States businesses and institutions of all sizes. Its primary customers are small and medium-sized companies, but it also addresses large-sized organizations MRO needs.

Grainger Industrial Supply operates 388 branches in all 50 states. These branches are located within 20 minutes of the majority of U.S. businesses and carry inventory to support their local market needs. Products are available for immediate pickup or for shipment.

On average, a branch is 20,000 square feet, has 12 employees, and handles about 239 transactions per day. During 2001, an average of approximately 93,000 sales transactions were completed daily. Grainger Industrial Supply s branches range in size from small storefront branches to large master branches. Storefront branches are used to fulfill will-call needs and customer service. Grainger Industrial Supply has five master branches which range in size from 43,000 square feet to 109,000 square feet and stock the fastest selling 30,000 items. In 2001, Grainger Industrial Supply invested more than $4,000,000 in new branches, branch relocations, and branch additions. During the year, 13 new branches were opened, seven were relocated, seven were closed, and a number of remodeling projects were completed.

Grainger Industrial Supply currently operates four Distribution Centers and two new highly automated distribution centers (DCs). DCs ship orders directly to customers for all branches located in their service area, including Internet orders, and replenish branch inventories. Two Regional Distribution Centers located in Greenville County, South Carolina, and Kansas City, Missouri, replenish DC inventories and some branches not served by a DC. A National Distribution Center, located in Niles, Illinois, is a centralized storage and shipping facility serving customers and the entire network with slower moving inventory items.

In 2000, Grainger Industrial Supply began a multi-year redesign and expansion of its distribution network that will allow the Company to remove a warehousing step from the current distribution system. This redesign is not only intended to reduce costs but also to increase capacity. As part of the redesign, Grainger Industrial Supply is transitioning its existing zone and regional warehouses into more highly automated distribution centers. Five new and four redesigned facilities will take over most of the shipping currently handled by the branches. When the transition is complete, each distribution center will average more than 300,000 square feet in size, employ state-of-the-art equipment and processes, and stock 60,000 to 70,000 of the fastest selling items.

Grainger Industrial Supply sells principally to service shops, industrial and commercial maintenance departments, manufacturers, hotels, government, contractors, and health care and educational facilities. Sales transactions during 2001 were made to approximately 1,300,000 customers. It is estimated that approximately 23% of 2001 sales consisted of items bearing the Company s registered trademarks, including DAYTON® (principally electric motors, heating and ventilation equipment), TEEL® (liquid pumps), SPEEDAIRE® (air compressors), AIR HANDLER® (air filtration equipment), DEM-KOTE® (spray paints), WESTWARD® (hand and power tools), and LUMAPRO® (task and outdoor lighting), as well as other of the Company s trademarks. The Company has taken steps to protect these trademarks against infringement and believes that they will remain available for future use in its business. Sales of remaining items generally consisted of products carrying the names of other well-recognized brands.

The Grainger Industrial Supply catalog offers almost 100,000 MRO products from more than 1,100 suppliers, most of whom are manufacturers. Approximately 1.8 million copies of the catalog were produced in 2001. The most current edition was issued in February 2002. The largest supplier in 2001, a diversified manufacturer through 18 of its divisions, accounted for about 9% of Grainger Industrial Supply s purchases. No significant difficulty has been encountered with respect to sources of supply.

The Grainger Industrial Supply CD-ROM catalog is designed to bring directly to the customer s place of business a fast, easy way to select products. Through the CD-ROM catalog, the customer can use a variety of ways to describe a needed product, and then review Grainger Industrial Supply s offerings, complete with specifications, prices, and pictures. Another CD-ROM catalog feature includes a cross-reference function that allows customers to retrieve product information using their own stock numbers. Approximately 1.4 million copies of the CD-ROM catalog were produced in 2001. The CD-ROM catalog is also used at the branches as a training tool and resource for helping customers identify appropriate products for their applications.

Customers can also utilize Grainger.com, one of the industry s first MRO websites. This website is an e-storefront or point of access into the Grainger Industrial Supply business. Grainger.com, however, offers more products than the Grainger Industrial Supply catalog, as well as automated search and customer personalization. It also is available 24 hours a day, seven days a week, providing real-time product availability, customer-specific pricing, multiple product search capabilities, and linkage to customer support and the fulfillment system. For large customers interested in connecting to Grainger.com using sophisticated purchasing platforms, Grainger.com has a universal connection. This technology translates the different data formats used by electronic marketplaces, exchanges, and e-procurement systems and allows information from these systems to be fed directly into Grainger Industrial Supply s operating platform.

The Grainger.com site serves as a prominent service channel for Grainger Industrial Supply. Customers have access to a much larger selection of MRO products through Grainger.com, which has more than 260,000 products available. Orders processed through Grainger.com resulted in sales of approximately $333,000,000 in 2001, $267,000,000 in 2000, and $101,000,000 in 1999.

Acklands-Grainger Inc. (AGI)

AGI, acquired in December 1996, is Canada s leading broad-line distributor of industrial, fleet, and safety supplies. It serves customers through 184 branches and six distribution centers across Canada. AGI distributes tools, lighting, HVAC, safety supplies, pneumatics, instruments, welding equipment and supplies, motors, and shop equipment, as well as many other items. A comprehensive catalog, printed in both English and French, is used to showcase the product line and to help customers select products. This catalog, with over 70,000 products listed, supports the efforts of approximately 260 field sales representatives throughout Canada. During 2001, an average of approximately 18,000 sales transactions were completed daily. On February 1, 2002, the Company finalized a joint venture agreement combining AGI s automotive aftermarket parts division and the Western Division of Uni-Select Inc., a Canadian distributor of automotive and industrial supplies. The Company has a 50 percent stake in the new company, which is managed by Uni-Select.

FindMRO

FindMRO is a sourcing center for indirect material spot buys. Through sophisticated search technologies, and the sourcing expertise of its professionals, FindMRO facilitates the location of MRO products when a source is unknown to the buyer. With access to a database of more than 8,000 suppliers and 5,000,000 products, FindMRO sources hard-to-find facilities maintenance supplies for their customers providing them with a one-stop shopping experience.

Grainger Global Sourcing

Grainger Global Sourcing procures competitively priced, high-quality products produced outside the United States. These items are sold primarily under private label by Grainger Industrial Supply and the Company s other businesses. Products obtained through Grainger Global Sourcing in 2001 include WESTWARD® tools and LUMAPRO® lighting products, as well as products bearing other trademarks.

Grainger Parts

Grainger Parts provides access to over 440,000 parts and accessories through its centralized warehouse located in Northbrook, Illinois. Trained representatives have access to more than 260,000 pages of detailed parts diagrams online. Customers can purchase over the telephone or online at Grainger.com. Grainger Parts handled about 1,740,000 customer calls in 2001 through its call centers in Northbrook, Illinois, and Waterloo, Iowa.

Grainger Parts has been ISO 9002 certified since 1995. Grainger Parts' 100% compliance with ISO 9002 standards ranked it among the top 10% of all ISO-certified companies.

Grainger, S.A. de C.V.

Grainger, S.A. de C.V. serves the MRO product needs of customers in Mexico. The business employed 51 sales representatives at December 31, 2001. From its five branches, the business provides delivery of over 70,000 products throughout Mexico. Three new branches were opened in 2001 in Tijuana, Mexico City, and Puebla. The largest branch, an 80,000 square foot facility, is located outside of Monterrey.

Digital Businesses

In January 2001, the Company announced it had consolidated three of its digital businesses into a separate organization. TotalMRO.com, FindMRO, and MROverstocks.com were combined to create Material Logic, which was designed to allow large customers to access a single, networked catalog. Material Logic sought funding participation from other industrial distributors and investors. Economic and market conditions made it difficult to find funding partners and in April 2001, the Company announced it was discontinuing the operations of Material Logic. All of Material Logic s branded e-commerce sites were shut down with the exception of FindMRO, which remains as an integrated sourcing service for Grainger s customers, under the Branch-based Businesses segment.

Lab Safety Supply, Inc.

Lab Safety Supply is a direct marketer of safety and other industrial products to U.S. and Canadian businesses. Located in Janesville, Wisconsin, Lab Safety Supply primarily reaches its customers through its General Catalog, targeted catalogs, and other marketing materials, which are distributed throughout the year.

Lab Safety Supply offers extensive product depth, technical support, and high service levels. It is a primary safety supplier for many small and medium-sized companies and a critical backup supplier for many larger companies. Customers have access to over 41,000 products in Lab Safety Supply s General Catalog. In addition, customers can access products using a CD-ROM version of the catalog or online via the web at LabSafety.com. In 2001, Lab Safety Supply acquired The Ben Meadows Co., a $20 million business-to-business direct marketer of equipment for the natural resources and forestry management market.

Other Businesses

In prior years, the Other Businesses category included a number of operating entities. For 2001, Grainger Integrated Supply is the only entity in the Other Businesses category.

Grainger Integrated Supply

Grainger Integrated Supply serves customers who have chosen to outsource components or all of their indirect materials management processes. The service offering is designed to enable customers to focus on their core business objectives.

Grainger Integrated Supply offers a full complement of on-site outsourcing solutions, including business process reengineering, inventory and tool crib management, supply chain management, purchasing management, and information management. Grainger Integrated Supply provides its clients with access to more than 5,000,000 products through its relationships with respected manufacturers, service providers, Grainger Industrial Supply, and other distributors.

Industry Segments

For 2001 the Company is reporting three industry segments: Branch-based Distribution, Digital, and Lab Safety Supply. For segment information and the Company's consolidated net sales and operating earnings see "Item 7: Management's Discussion and Analysis of Financial Condition and the Results of Operations," and "Item 8: Financial Statements and Supplementary Data." The total year-end assets of the Company for the last five years were: 2001, $2,331,246,000; 2000, $2,459,601,000; 1999, $2,564,826,000; 1998, $2,103,966,000; and 1997, $2,000,116,000.

Competition

The Company faces competition in all the markets it serves, from manufacturers (including some of the Company s own suppliers) that sell directly to certain segments of the market, from wholesale distributors, from catalog houses, from certain Internet-based businesses and product fulfillment mechanisms, and from certain retail enterprises.

The principal means by which the Company competes with manufacturers and other distributors are by local stock availability, efficient service, account managers, competitive pricing, its several catalogs, which include product descriptions and in certain cases, extensive technical and application data, electronic and Internet commerce technology, and other efforts to assist customers in lowering their total MRO costs. The Company believes that it can effectively compete on a price basis with its manufacturing competitors on small orders, but that such manufacturers may enjoy a cost advantage in filling large orders.

The Company serves a number of diverse markets and is able in some markets to reasonably estimate the Company s competitive position within that market. However, taken as a whole, the Company is unable to determine its market share relative to others engaged in whole or in part in similar activities.

Employees

As of December 31, 2001, the Company had 15,385 employees, of whom 13,342 were full-time and 2,043 were part-time or temporary. The Company has never had a major work stoppage and considers its employee relations generally to be good.

Item 2: Properties

As of December 31, 2001, the Company s owned and leased facilities totaled 17,886,000 square feet, an increase of 1.5% over 2000. Grainger Industrial Supply and Acklands-Grainger Inc. (AGI) accounted for the majority of the total square footage. Grainger Industrial Supply facilities are located throughout the United States. AGI facilities are located throughout Canada.

Grainger Industrial Supply branches range in size from 1,200 to 109,000 square feet and average 20,000 square feet. Most are located in or near major metropolitan areas. Many are in industrial parks. Typically, a branch is on one floor, is of masonry construction, consists primarily of warehouse space, contains an air-conditioned office and sales area, and has off-the-street parking for customers and employees. The Company considers that its properties are generally in good condition and well maintained and are suitable and adequate to carry on the Company s business.

The significant facilities of the Company are briefly described below:

Location	Facility and Use	Size i Square F
Chicago Area (1)	General Offices & National Distribution Center	2,041,
Kansas City, MO (1)	Regional Distribution Center	1,435,
Greenville County, SC (1)	Regional Distribution Center	1,090,
United States (1)	Six Distribution Centers	1,709,
United States (2)	388 Grainger Industrial Supply branch locations	7,631,
United States and Mexico (3)	All other facilities	1,710,
Canada (4)	184 AGI facilities	2,270,
	Total square feet	17,886,

(1) These facilities are either owned or leased with most leases expiring between 2002 and 2011. The owned facilities are not subject to any mortgages.

(2) Grainger Industrial Supply branches consist of 285 owned and 103 leased properties. The owned facilities are not subject to any mortgages.

(3) Other facilities represent owned and leased general branch offices, distribution centers, and branches. Two branches are located in Puerto Rico and five are located in Mexico. The owned facilities are not subject to any mortgages.

(4) AGI facilities consist of general offices, distribution centers, and branches that are either owned or leased. The owned facilities are not subject to any mortgages.

Item 3: Legal Proceedings

There are pending various legal and administrative proceedings involving the Company that are incidental to the business. It is not expected that the outcome of any such proceeding will have a material adverse effect upon the Company s consolidated financial position or its results of operations.

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

No matters were submitted to a vote of security holders during the fourth quarter of 2001.

Executive Officers of the Company

Following is information about the Executive Officers of the Company as of March 1, 2002.

Executive Officers of the Company generally serve until the next annual election of officers, or until earlier resignation or removal.

Name and Age	Positions and Offices Held and Principal Occupations and Employment During the Past Five
Wesley M. Clark (49)	President and Chief Operating Officer, a position assumed in 20 President. Before assuming the last-mentioned position in 1997, Senior Vice President, Operations and Quality.
Timothy M. Ferrarell (45)	Senior Vice President, Enterprise Systems, a position assumed i Vice President, Quality and Business Planning. Before assuming position in 1998, Mr. Ferrarell served as Vice President, Marke Previously, he served as Vice President, Marketing.
Nancy A. Hobor (55)	Vice President, Communications and Investor Relations. Before j 1999, Ms. Hobor was Vice President, Corporate Communications an Morton International, Inc.
John L. Howard (44)	Senior Vice President and General Counsel. Before joining the C Howard was Vice President and General Counsel of Tenneco Automo after serving as Vice President, Law and Assistant General Coun
Richard L. Keyser (59)	Chairman of the Board, a position assumed in 1997, and Chief Ex position assumed in 1995. Previously, Mr. Keyser served as the Chief Operating Officer.
Larry J. Loizzo (47)	Vice President of the Company and President of Lab Safety Suppl
P. Ogden Loux (59)	Senior Vice President, Finance and Chief Financial Officer, pos after serving as Vice President, Finance.
Peter M. Perez (48)	Senior Vice President, Human Resources. Before joining the Comp was Chief Human Resource Officer at Alliant Exchange/Clayton Du Previously, he was Senior Vice President, Human Resources of Wh Cola.
James T. Ryan (43)	Executive Vice President, Marketing, Sales and Service. Until a in 2001, Mr. Ryan served as Vice President of the Company and P Previously, he served as Vice President, Information Services.
John A. Schweig (44)	Senior Vice President, Business Development and International.
John W. Slayton, Jr. (56)	Senior Vice President, Supply Chain Management, a position assu as Senior Vice President, Product Management.

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PART II

Item 5: Markets for Registrant's Common Equity and Related Shareholder Matters

The Company's common stock is traded on the New York Stock Exchange and the Chicago Stock Exchange, with the ticker symbol GWW. The high and low sales prices for the common stock and the dividends declared and paid for each calendar quarter during 2001 and 2000 are shown below.

		Prices		
	Quarters	High	Low	Dividends
2001	First	$39.78	$29.51	$0.170
	Second	48.00	32.00	0.175
	Third	45.25	36.86	0.175
	Fourth	48.99	37.85	0.175
	Year	$48.99	$29.51	$0.695
2000	First	$56.88	$37.25	$0.160
	Second	55.69	29.38	0.170
	Third	34.75	25.13	0.170
	Fourth	40.00	24.31	0.170
	Year	$56.88	$24.31	$0.670

The approximate number of shareholders of record of the Company's common stock as of March 4, 2002 was 1,700.

Item 6: Selected Financial Data

	Years Ended December		
	(In thousands of dollars except for		
	2001	2000	1999
Net sales..	$4,754,317	$4,977,044	$4,636,275
Net earnings.....................................	174,530	192,903	180,731
Net earnings per basic share.....................	1.87	2.07	1.95
Net earnings per diluted share...................	1.84	2.05	1.92
Total assets.....................................	2,331,246	2,459,601	2,564,826
Long-term debt...................................	118,219	125,258	124,928
Cash dividends paid per share....................	$ 0.695	$ 0.670	$ 0.630

The results for 2001 included a non-recurring after-tax charge of $36,650,000, or $0.39 per share.

The results for 2000 included an after-tax gain of $17,860,000, or $0.19 per share, related to sales of investment securities. For further information see Item 7: Management s Discussion and Analysis of Financial Condition and Results of Operations, and Note 3 and Note 9 to the Consolidated Financial Statements.

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

RESULTS OF OPERATIONS

The following table is included as an aid to understanding changes in the Company's Consolidated Statements of Earnings.

	Years Ended Dece		
	Items in Consolidated Statements of Earnings as a Percent of Net Sales		
	2001	2000	1999
Net sales..	100.0%	100.0%	100.0%
Cost of merchandise sold...........................	66.6	68.2	67.4
Operating expenses.................................	26.3	25.1	25.8
Operating earnings.................................	7.1	6.7	6.8
Other deductions, net..............................	0.8	0.0	0.3
Income taxes.......................................	2.6	2.8	2.6
Net earnings.......................................	3.7%	3.9%	3.9%

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Company Net Sales-- 2001 Compared to 2000

The Company s net sales of $4,754,317,000 for 2001 decreased 4.5% from net sales of $4,977,044,000 for 2000. This decrease resulted from a 5.2% decrease in the Branch-based Distribution Businesses segment, a 46.2% decrease in the Digital Businesses segment, and a 1.6% decrease at Lab Safety Supply, partially offset by a 5.5% increase in the Other Businesses of the Company. The year 2001 had the same number of sales days as 2000 (255). Sales performance was affected by the general weakness in the North American economy and worsened by quarter throughout the year.

Segment Net Sales

The following comments at the segment level include external and intersegment net sales; those comments at the business unit level include external and inter- and intrasegment net sales. For segment information see Note 19 to the Consolidated Financial Statements.

Branch-based Distribution Businesses

Net sales at the Branch-based Distribution Businesses amounted to $4,251,596,000 in 2001, a 5.2% decrease as compared with 2000 sales of $4,483,777,000.

Sales in the United States decreased in 2001 as compared with 2000 primarily due to the recession in the United States. Also contributing to the decline was a decrease in the sales of seasonal products due to relatively mild weather in the summer and winter seasons. Sales to government accounts increased while other categories declined.

Sales were favorably affected by continued momentum in the Company s Internet strategy. For 2001, Grainger.com processed sales of approximately $333,000,000, a 24.7% increase from the $267,000,000 processed in 2000.

In Canada, average daily sales decreased 2.8% in 2001 as compared with 2000. This decrease was driven primarily by an unfavorable Canadian exchange rate. In local currency, average daily sales increased 1.3% in 2001 as compared with 2000. The growth in Canada was driven primarily by an improvement in the oil and gas sector of the economy, partially offset by the impact of the weakness in other sectors of the Canadian economy. The Company s Canadian operations also experienced a negative sales trend with sales declining in the second half of the year on a comparative basis with 2000.

In Mexico, average daily sales decreased 17.0% in 2001 as compared with 2000. This sales performance reflects the weakness in the automotive and electronics manufacturing industries, deterioration of the Mexican economy, along with the impact of the recession in the United States.

Digital Businesses

Net sales at the Digital Businesses amounted to $29,979,000 in 2001, a 46.2% decrease as compared with 2000 sales of $55,683,000. Net sales for this segment represented product sales and service fee revenues for FindMRO and service fee revenues for the rest of Material Logic.

On April 23, 2001, the Company announced that it would shut down the operations of Material Logic with the exception of FindMRO. In connection with this announcement, the Company took a pretax, non-recurring charge of $39.1 million in 2001. FindMRO was then established as an operating unit separate from Material Logic. Effective June 1, 2001, FindMRO was added to the Branch-based Distribution Businesses. Beginning with the 2001 third quarter, the Digital Businesses segment ceased operations. For additional information, see Note 3 to the Consolidated Financial Statements.

Lab Safety Supply

Net sales at Lab Safety Supply amounted to $324,797,000 in 2001, a 1.6% decrease compared with 2000 sales of $330,108,000. Lab Safety Supply s sales included the results of The Ben Meadows Co., an acquisition made in the 2001 first quarter. Excluding the sales of The Ben Meadows Co., 2001 sales would have been down 6.2% when compared with 2000, primarily the result of weak sales in the nation s industrial sector.

Other Businesses

Net sales at the Other Businesses amounted to $190,811,000 in 2001, a 5.5% increase over 2000 sales of $180,852,000. Sales growth for this group of businesses was primarily related to a strong sales increase at Grainger Integrated Supply. Sales for this business unit included product sales and management fees.

Company Net Sales-- 2000 Compared to 1999

The Company s net sales of $4,977,044,000 for 2000 increased 7.4% from net sales of $4,636,275,000 for 1999. This increase resulted from a 6.5% increase in the Branch-based Distribution Businesses segment, a 1,769.2% increase in the Digital Businesses segment, a 5.3% increase at Lab Safety Supply, and a 43.7% increase in the Other Businesses of the Company. The year 2000 had one more sales day than did 1999 (255 versus 254). On a daily basis the Company s net sales increased 6.9%.

Sales growth for 2000 was primarily volume driven, reflecting growth in the Branch-based Businesses, especially in Canada and Mexico; strong growth at Grainger Integrated Supply; and continued strong growth in sales processed through the Company s Internet sites.

Sales processed through the Company's Internet businesses, as represented by the Digital segment plus Grainger.com, amounted to $337,000,000 in 2000, a 230% increase as compared with $102,000,000 for the year 1999.

The Company's sales growth during the fourth quarter of 2000 was negatively affected by a slowing economy.

Segment Net Sales

The following comments at the segment level include external and intersegment net sales; those comments at the business unit level include external and inter- and intrasegment net sales. For segment information see Note 19 to the Consolidated Financial Statements.

Branch-based Distribution Businesses

Net sales at the Branch-based Distribution Businesses amounted to $4,483,777,000 in 2000, a 6.5% increase over 1999 sales of $4,211,316,000. Average daily sales increased by 6.1%.

The Company s Canadian operations experienced double-digit sales growth. The growth was the result of strong sales across most of Canada. The growth was driven by an improvement in the oil and gas, forestry, and mining sectors of the Canadian economy, gains in large customer accounts, and the opening of 10 new branches during 1999.

The Company s Mexican operations experienced double-digit sales growth reflecting the continued development of this business. This growth in sales was attributable to an expanded product offering and account penetration. In January 2000, the Company opened a second branch in Mexico.

Sales growth in the United States was driven by improved sales at Grainger Industrial Supply. Contributing to the sales growth were 35 new branches opened during 1999 and 2000. Also contributing to the sales growth was increased sales to government accounts.

Sales were also favorably affected by continued momentum in the Company s Internet initiative. Sales orders processed through Grainger.com amounted to $267,000,000 in 2000, a 164% increase over 1999 sales of $101,000,000.

Partially offsetting this growth was the impact of a 20% decline in third quarter sales of seasonal products resulting from relatively mild weather in the more heavily populated areas of the United States. Also, sales growth during the fourth quarter of 2000 was negatively affected by a slowing economy.

Digital Businesses

Net sales at the Digital Businesses amounted to $55,683,000 in 2000, a significant increase over 1999 sales of $2,979,000. Sales for this group of businesses include product sales and service fee revenues for FindMRO and service fee revenues for MROverstocks.com (formerly Grainger Auction) and TotalMRO.com. FindMRO and MROverstocks.com were officially launched in November 1999. TotalMRO.com opened for business on March 31, 2000.

Lab Safety Supply

Net sales at Lab Safety Supply amounted to $330,108,000, a 5.3% increase over 1999 sales of $313,533,000. This increase reflects the continued growth in sales of industrial products and expanded market share attained through new customers and further penetration of existing accounts. Partially offsetting this increase was a decline in sales of safety products resulting from a slowing of the industrial economy in the United States.

Other Businesses

Net sales at the Other Businesses amounted to $180,852,000 in 2000, a 43.7% increase over 1999 sales of $125,882,000.

Sales growth for this group of businesses was primarily related to a strong sales increase at Grainger Integrated Supply. Sales for this business unit include product sales and management fees. Growth was driven by new engagements, contract renewals, and scope expansions, reflecting increasing demand for this outsourcing business, which provides fee-based, on-site indirect materials management services to large businesses.

Company Net Earnings-- 2001 Compared to 2000

The Company s net earnings of $174,530,000 for 2001 decreased 9.5% compared with 2000 net earnings of $192,903,000. The Company s earnings per share for the year declined 10.2% to $1.84 in 2001 from $2.05 in 2000. The results for 2001 included a non-recurring, after-tax charge of $36,650,000, or $0.39 per share. The results for 2000 included an after-tax gain of $17,860,000, or $0.19 per share, related to sales of investment securities. Excluding these non-recurring items from both periods, net earnings increased 20.6% to $211,180,000 in 2001 from $175,043,000 in 2000 and earnings per share increased 19.9% to $2.23 in 2001 from $1.86 in 2000.

Segment Operating Earnings

The following comments at the segment level include external and intersegment operating earnings; those comments at the business unit level include external and inter- and intrasegment operating earnings. For segment information see Note 19 to the Consolidated Financial Statements.

Branch-based Distribution Businesses

Operating earnings of $386,331,000 declined 2.7% in 2001 as compared with $397,252,000 for 2000. Lower sales and an increase in operating expenses contributed to the decline in operating earnings, partially offset by a higher gross profit margin.

Operating expenses increased 1.9% in 2001 versus 2000. Operating expenses increased due to higher occupancy expenses, including the effect of start-up costs relating to the opening of two new distribution centers, increased data processing expenses and increased employee benefits costs. These factors were partially offset by lower travel and entertainment expenses and lower advertising expenses.

The gross profit margin was affected by selected pricing actions in 2001 intended to cover freight and supplier cost increases, and lower sales of seasonal products. Historically, the sales of seasonal products have lower than average gross profit margins.

Digital Businesses

On April 23, 2001, the Company announced that it would shut down the operations of Material Logic with the exception of FindMRO. In connection with this announcement, the Company took a pretax, non-recurring charge of $39,070,000 in 2001. FindMRO was then established as an operating unit separate from Material Logic. Effective June 1, 2001, FindMRO was added to the Branch-based Distribution Businesses. Beginning with the 2001 third quarter, the Digital Businesses segment ceased operations.

The Digital Businesses incurred operating losses of $49,227,000 in 2001 which included the non-recurring charge of $39,070,000 mentioned above. This compares with operating losses of $48,207,000 in 2000. For additional information, see Note 3 to the Consolidated Financial Statements.

Lab Safety Supply

Operating earnings of $51,114,000 decreased 7.1% in 2001 as compared with $55,037,000 for 2000. The decrease in operating earnings was impacted by the decline in net sales and an increase in payroll and employee benefits costs, and increased data processing costs.

Other Businesses

The Other Businesses achieved operating income of $449,000 in 2001 compared with operating losses of $13,257,000 in 2000. This increase was primarily attributable to improved operating results at Grainger Integrated Supply. These results were achieved by eliminating or renegotiating unprofitable contracts and by reducing its cost structure through improved productivity.

Other Income Statement Data

Other income or deductions included the following non-recurring items:

1. In 2001, a $25,123,000 loss relating to investments in digital enterprises.
2. In 2000, a gain of $30,017,000 from the sale of investment securities.

Excluding the non-recurring items from both periods, the year 2001 had a net deduction of $16,170,000 versus a net deduction of $33,542,000 in the comparable 2000 period. The difference was primarily attributable to lower interest expense.

The Company's effective tax rate was 41.3% and 41.8% in 2001 and 2000, respectively. The rate decrease in 2001 as compared with 2000 was primarily due to the following two items, which lowered the effective tax rate for 2001 when compared with 2000:

1. Lower amounts of losses in unconsolidated entities; and
2. The tax impact of the write-off of investments in unconsolidated entities, which had tax benefits disproportionate to the loss incurred.

These items were partially offset by the tax impact of capital losses which are not deductible in the absence of capital gains.

Excluding the effect of these items, the effective tax rate was 40.5% for both 2001 and 2000.

<u>Company Net Earnings-- 2000 Compared to 1999</u>

The Company's net earnings of $192,903,000 for 2000 increased 6.7% as compared with 1999 net earnings of $180,731,000. This increase resulted from higher operating earnings and lower other deductions, partially offset by a higher effective income tax rate.

Operating earnings improved at the Branch-based Distribution Businesses and at Lab Safety Supply. Also, the operating losses at the Other Businesses decreased. These improvements were partially offset by the increased operating losses at the Digital Businesses.

Segment Operating Earnings

The following comments at the segment level include external and intersegment operating earnings; those comments at the business unit level include external and inter- and intrasegment operating earnings. For segment information see Note 19 to the Consolidated Financial Statements.

Branch-based Distribution Businesses

Operating earnings at the Branch-based Distribution Businesses amounted to $397,252,000 in 2000, an 11.0% increase over 1999 operating earnings of $357,925,000. This improvement in operating earnings was greater than the sales increase because operating expenses grew at a slower rate than the growth in sales, partially offset by lower gross profit margins.

Operating expenses increased 2%, primarily the result of productivity improvements. Partially offsetting these improvements were higher data processing expenses (including increased depreciation, amortization, and systems maintenance costs) and increased bad debt provisions.

Gross profit margins decreased 0.67 percentage point as compared to 1999. Of note are the following factors affecting the gross profit margin:

1. Grainger Industrial Supply's gross profit margin declined. This decline was primarily due to an unfavorable change in selling price category mix resulting from increased sales of sourced products and to higher freight costs. The above factors were partially offset by selected price increases during the 2000 third quarter. The price increases were intended to recover freight and supplier cost increases.
2. Acklands-Grainger Inc. had a lower gross profit margin primarily due to an unfavorable change in selling price category mix as a result of increased sales to large customers.

Digital Businesses

The Digital Businesses incurred operating losses of $48,207,000 in 2000 compared with operating losses of $20,560,000 in 1999. During 2000 the Company continued to invest in developing, enhancing, operating, and marketing these digital businesses.

Total operating expenses associated with the Company's Internet initiatives, as represented by this segment plus Grainger.com (which is included in the Branch-based Distribution Businesses segment), were $108,000,000 in 2000 as compared with $42,000,000 in 1999.

On August 1, 2000, the Company combined OrderZone.com with Works.com, a leading Internet purchasing service. This combination was designed to provide small and mid-size businesses with online purchasing services for indirect business products. The Company received a 40% interest in the combined entity and recognized a proportionate share of earnings or losses as part of Other Deductions.

On January 26, 2001, the Company announced the consolidation of FindMRO, MROverstocks.com, and TotalMRO.com into a separate organization, Material Logic. Participation was sought from MRO distributors to establish Material Logic as an industry-backed, industry-funded independent entity that would own and operate these businesses. Material Logic was also expected to include related consulting, implementation, and content services.

Lab Safety Supply

Operating earnings at Lab Safety Supply amounted to $55,037,000 in 2000, a 28.4% increase over 1999 operating earnings of $42,878,000. This increase resulted from improved operating performance and the elimination of expenses related to certain fully amortized intangibles.

Other Businesses

The Other Businesses of the Company incurred operating losses of $13,257,000 in 2000 compared with operating losses of $16,306,000 in 1999. The lower operating losses for this group of companies was a function of improved performance at all of the businesses grouped under this caption, including Grainger Integrated Supply.

Other Income Statement Data

Interest expense of $24,403,000 for 2000 increased by $8,807,000 as compared with 1999. This increase resulted from higher average borrowings, higher average interest rates paid on all outstanding debt, and lower capitalized interest.

The equity in losses of unconsolidated entities (after tax) primarily related to the Company s interest in Works.com, which was acquired during the 2000 third quarter.

Unclassified net income for 2000 was $29,842,000 versus $512,000 for 1999. The year 2000 included a $30,017,000 gain from the sales of investment securities.

The Company s effective income tax rate was 41.8% for 2000 and 40.5% for 1999. The increase in the effective income tax rate relates to the loss on equity interest in unconsolidated entities, which is a net of tax number. Excluding the effect of these joint venture losses, the effective income tax rate was 40.5% for both years.

FINANCIAL CONDITION

Working capital was $838,800,000 at December 31, 2001, compared with $735,678,000 at December 31, 2000, and $600,611,000 at December 31, 1999. The ratio of current assets to current liabilities was 2.5, 2.0, and 1.7, at such dates.

Net cash flows from operations of $510,794,000 in 2001, $277,757,000 in 2000, and $37,240,000 in 1999, have continued to improve the Company s financial position and serve as the primary source of funding for capital requirements. For information as to the Company s cash flows, see Item 8: Financial Statements and Supplementary Data.

In each of the past three years, a portion of working capital has been used for additions to property, buildings, equipment, and capitalized software as summarized in the following table.

	2001	2000
	(In thousands of dol	
Land, buildings, structures, and improvements	$ 26,534	$ 32,822
Furniture, fixtures, machinery, and equipment	73,917	32,685
	100,451	65,507
Capitalized software	6,717	29,406
Total	$ 107,168	$ 94,913

The Company repurchased 1,820,000 shares of its common stock during 2001, 31,400 shares of its common stock during 2000, and 355,300 shares of its common stock during 1999. As of December 31, 2001, approximately 3,500,000 shares of common stock remained available under the Company s repurchase authorization.

Dividends paid to shareholders were $65,445,000 in 2001, $62,863,000 in 2000, and $58,817,000 in 1999.

Internally generated funds have been the primary source of working capital and funds needed for expanding the business, supplemented by debt as circumstances dictated. In addition to continuing facilities optimization efforts, business development, and systems and other infrastructure enhancements, funds are being expended to enhance the Company s Internet initiatives.

The Company maintains a debt ratio and liquidity position that provide flexibility in funding working capital needs and long-term cash requirements. In addition to internally generated funds, the Company has various sources of financing available, including commercial paper sales and bank borrowings under lines of credit and otherwise. Total debt as a percent of Shareholders Equity was 8%, 21%, and 30% at December 31, 2001, 2000, and 1999, respectively.

INFLATION AND CHANGING PRICES

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

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

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

FORWARD-LOOKING STATEMENTS

Throughout this Form 10-K are forward-looking statements under the federal securities laws. The forward-looking statements relate to the Company s expected future financial results and business plans, strategies, and objectives and are not historical facts. They are often identified by qualifiers such as: will, intended, is transitioning, or similar expressions. There are risks and uncertainties the outcome of which could cause the Company s results to differ materially from what is projected.

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

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

Item 7A: Quantitative and Qualitative Disclosures about Market Risk

The Company is exposed to foreign currency exchange risk related to its transactions, assets, and liabilities denominated in foreign currencies. The Company partially hedges the net Canadian dollar investment of its Canadian subsidiary with borrowings denominated in Canadian dollars. See Note 13 to the Consolidated Financial Statements for additional information regarding this Canadian dollar denominated financing. For 2001, a uniform 10 percent strengthening of the U.S. dollar relative to foreign currencies in which the Company s sales are made would not have had a material effect on net income. This sensitivity analysis of the effects of changes in foreign currency exchange rates does not factor in potential changes in sales levels or local currency prices.

The Company also is exposed to interest rate risk in its debt portfolio. All of the Company s long-term debt at December 31, 2001, is variable rate debt. See Note 13 to the Consolidated Financial Statements for the maturity schedule of the debt outstanding as of December 31, 2001. For 2001, a one percentage point increase in interest rates paid by the Company would result in a decrease in net income of approximately $0.9 million. This sensitivity analysis of the effects of changes in interest rates on long-term debt does not factor in potential changes in exchange rates or long-term debt levels.

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

Item 8: Financial Statements and Supplementary Data

The financial statements and supplementary data are included on pages 18 to 42. See the Index to Financial Statements and Supplementary Data on page 17.

Item 9: Disagreements on Accounting and Financial Disclosure

None.

PART III

Item 10: Directors and Executive Officers of the Registrant

Information regarding directors of the Company will be set forth in the Company's proxy statement relating to the annual meeting of shareholders to be held April 24, 2002, and, to the extent required, is incorporated herein by reference. Information regarding executive officers of the Company is set forth under the caption "Executive Officers of the Company."

Item 11: Executive Compensation

Information regarding executive compensation will be set forth in the Company's proxy statement relating to the annual meeting of shareholders to be held April 24, 2002, and, to the extent required, is incorporated herein by reference.

Item 12: Security Ownership of Certain Beneficial Owners and Management

Information regarding security ownership of certain beneficial owners and management will be set forth in the Company's proxy statement relating to the annual meeting of shareholders to be held April 24, 2002, and, to the extent required, is incorporated herein by reference.

Item 13: Certain Relationships and Related Transactions

Information regarding certain relationships and related transactions will be set forth in the Company's proxy statement relating to the annual meeting of shareholders to be held April 24, 2002, and, to the extent required, is incorporated herein by reference.

PART IV

Item 14: Exhibits, Financial Statement Schedule, and Reports on Form 8-K

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

2. Financial Statement Schedule. See Index to Financial Statements and Supplementary Data.

3. Exhibits:

(3) (a) Restated Articles of Incorporation dated April 27, 1994, incorporated 3(i) to the Company's Quarterly Report on Form 10-Q for the quarter e

(b) Bylaws, as amended, incorporated by reference to Exhibit 3 to the Com on Form 10-Q for the quarter ended June 30, 2001.

(10) Material Contracts:

(a) No instruments which define the rights of holders of the Company's In Revenue Bonds are filed herewith, pursuant to the exemption contained 601(b)(4)(iii). The Company hereby agrees to furnish to the Securitie Commission, upon request, a copy of any such instrument.

(b) Compensatory Plans or Arrangements

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

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

(iii) 1990 Long-Term Stock Incentive Plan, as amended.

(iv) 2001 Long-Term Stock Incentive Plan, as amended.

(v) Executive Death Benefit Plan, as amended.

(vi) Executive Deferred Compensation Plan, incorporated by reference to Ex Company's Annual Report on Form 10-K for the year ended December 31,

(vii) 1985 Executive Deferred Compensation Plan, as amended, incorporated b 10(d)(vii) to the Company's Annual Report on Form 10-K for the year e

(viii) Supplemental Profit Sharing Plan, as amended.

(ix) Form of Change in Control Employment Agreement between the Company an executive officers, incorporated by reference to Exhibit 10(c) to the on Form 10-K for the year ended December 31, 1999.

(11) Computations of Earnings Per Share. See Index to Financial Statements and Supplem

(21) Subsidiaries of the Company.

(23) Consent of Independent Certified Public Accountants. See Index to Financial State Data.

(b) Reports on Form 8-K. No reports on Form 8-K were filed during the last quarter of 2001.

SIGNATURES

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

DATE: March 19, 2002

W.W. GRAINGER, INC.

By: /s/ R. L. Keyser	By: /s/ P. O. Loux
R. L. Keyser Chairman of the Board and Chief Executive Officer	P. O. Loux Senior Vice President, Finance and Chief Financial Officer

/s/ Brian P. Anderson Brian P. Anderson Director	March 19, 2002	/s/ Neil S. Novich Neil S. Novich Director	March 19
/s/ Wesley M. Clark Wesley M. Clark Director	March 19, 2002	/s/ James D. Slavik James D. Slavik Director	March 19
/s/ Wilbur H. Gantz Wilbur H. Gantz Director	March 19, 2002	/s/ Harold B. Smith Harold B. Smith Director	March 19
/s/ David W. Grainger David W. Grainger Director	March 19, 2002	/s/ Fred L. Turner Fred L. Turner Director	March 19
/s/ Frederick A. Krehbiel Frederick A. Krehbiel Director	March 19, 2002	/s/ Janiece S. Webb Janiece S. Webb Director	March 19
/s/ John W. McCarter, Jr. John W. McCarter, Jr. Director	March 19, 2002		

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INDEX TO FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

December 31, 2001, 2000, and 1999

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REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Shareholders and Board of Directors

W.W. Grainger, Inc.

We have audited the accompanying consolidated balance sheets of W.W. Grainger, Inc., and Subsidiaries as of December 31, 2001, 2000, and 1999, and the related consolidated statements of earnings, comprehensive earnings, shareholders equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of W.W. Grainger, Inc., and Subsidiaries as of December 31, 2001, 2000, and 1999, and the consolidated results of their operations and their consolidated cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

We have also audited Schedule II of W.W. Grainger, Inc., and Subsidiaries for the years ended December 31, 2001, 2000, and 1999. In our opinion, this Schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information required to be set forth therein.

GRANT THORNTON LLP

Chicago, Illinois

January 28, 2002

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W.W. Grainger, Inc., and Subsidiaries

CONSOLIDATED STATEMENTS OF EARNINGS

(In thousands of dollars except for per share amounts)

	Years En	
	2001	
Net sales	$ 4,754,317	$
Cost of merchandise sold	3,165,030	
Gross profit	1,589,287	
Warehousing, marketing, and administrative expenses	1,211,644	
Restructuring charges	39,070	
Total operating expenses	1,250,714	
Operating earnings	338,573	
Other income or (deductions)		
Interest income	2,827	
Interest expense	(10,674)	
Equity in loss of unconsolidated entities	(7,205)	
Loss on liquidation of equity in unconsolidated entity	(20,123)	
Unclassified--net	(6,118)	
	(41,293)	
Earnings before income taxes	297,280	
Income taxes	122,750	
Net earnings	$ 174,530	$
Earnings per share:		
Basic	$ 1.87	$
Diluted	$ 1.84	$

Weighted average number of shares outstanding:		
Basic	93,189,132	9
Diluted	94,727,868	9

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

W.W. Grainger, Inc., and Subsidiaries

CONSOLIDATED STATEMENTS OF COMPREHENSIVE EARNINGS

(In thousands of dollars)

	Years En	
	2001	
Net earnings	$ 174,530	$
Other comprehensive earnings (loss) net of tax:		
Foreign currency translation adjustments	(15,457)	
Gain (loss) on investment securities:		
Unrealized holding gain (loss)	4,820	
Reclassification adjustments for realized gains included in net earnings	(84)	
	(10,721)	
Comprehensive earnings	$ 163,809	$

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

W.W. Grainger, Inc., and Subsidiaries

CONSOLIDATED BALANCE SHEETS

(In thousands of dollars)

	Dece	
ASSETS	2001	
CURRENT ASSETS		
Cash and cash equivalents	$ 168,846	$
Accounts receivable, less allowances for doubtful accounts of $30,552 for 2001, $23,436 for 2000, and $18,369 for 1999	454,180	
Inventories	634,654	
Prepaid expenses	37,477	
Deferred income tax benefits	97,454	
Total current assets	1,392,611	1
PROPERTY, BUILDINGS, AND EQUIPMENT		

Land	150,335	
Buildings, structures, and improvements	722,043	
Furniture, fixtures, machinery, and equipment	514,046	
	1,386,424	1
Less accumulated depreciation and amortization	696,706	
Property, buildings, and equipment--net	689,718	
DEFERRED INCOME TAXES	--	
INVESTMENTS IN UNCONSOLIDATED ENTITIES	4,776	
OTHER ASSETS		
Goodwill	177,753	
Customer lists and other intangibles	93,622	
	271,375	
Less accumulated amortization	115,892	
	155,483	
Investments	27,023	
Capitalized software--net	39,207	
Sundry	22,428	
Other assets--net	244,141	
TOTAL ASSETS	$ 2,331,246	$ 2

W.W. Grainger, Inc., and Subsidiaries

CONSOLIDATED BALANCE SHEETS - CONTINUED

(In thousands of dollars)

	Dece	
LIABILITIES AND SHAREHOLDERS' EQUITY	2001	
CURRENT LIABILITIES		
Short-term debt	$ 4,526	$
Current maturities of long-term debt	12,520	
Trade accounts payable	275,893	
Accrued compensation and benefits	64,549	
Accrued contributions to employees' profit sharing plans	60,103	
Accrued expenses	127,108	
Income taxes	9,112	
Total current liabilities	553,811	

LONG-TERM DEBT (less current maturities)	118,219
DEFERRED INCOME TAXES	1,239
ACCRUED EMPLOYMENT-RELATED BENEFITS COSTS	54,649
MINORITY INTEREST	139
SHAREHOLDERS' EQUITY	
Cumulative Preferred Stock-- $5 par value--authorized, 12,000,000 shares, issued and outstanding, none	--
Common Stock--$0.50 par value--authorized, 300,000,000 shares; issued, 108,473,703 shares, 2001, 108,037,082 shares, 2000, and 107,460,978 shares, 1999	54,237
Additional contributed capital	289,201
Retained earnings	1,937,972
Unearned restricted stock compensation	(17,722)
Accumulated other comprehensive (loss) earnings	(29,553)
Treasury stock, at cost--15,129,062 shares, 2001, 14,104,212 shares, 2000, and 14,079,292 shares, 1999	(630,946)
Total shareholders' equity	1,603,189
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 2,331,246

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

W.W. Grainger, Inc., and Subsidiaries

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands of dollars)

	Years Ende
	2001
Cash flows from operating activities:	
Net earnings	$ 174,530
Provision for losses on accounts receivable	21,483
Depreciation and amortization:	
Property, buildings, and equipment	77,737
Intangibles and goodwill	5,989
Capitalized software	19,483
Tax benefit of stock incentive plans	1,814
(Gain) on sales of investment securities	(138)
Noncash restructuring charge	11,996
Asset write-downs	7,400
Loss on unconsolidated entities	25,228
Change in operating assets and liabilities--	

net of business acquisition and asset write-downs:	
Decrease (increase) in accounts receivable	130,521
Decrease (increase) in inventories	66,446
(Increase) in prepaid expenses	(13,286)
(Increase) in deferred income taxes	(6,853)
(Decrease) increase in trade accounts payable	(7,168)
Increase (decrease) in other current liabilities	12,773
(Decrease) increase in current income taxes payable	(26,243)
Increase in accrued employment-related benefits costs	5,112
Other--net	3,970
Net cash provided by operating activities	510,794
Cash flows from investing activities:	
Additions to property, buildings, and equipment	(100,451)
Proceeds from sale of property, buildings, and equipment--net	10,467
Expenditures for capitalized software	(6,717)
Proceeds from sales of investment securities	1,015
Purchases of investment securities	--
Net cash paid for business acquisition	(14,407)
Investments in unconsolidated entities	(5,764)
Other--net	180
Net cash (used in) investing activities	(115,677)

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W.W. Grainger, Inc., and Subsidiaries

CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED

(In thousands of dollars)

	Years Ende	
	2001	
Cash flows from financing activities:		
Net (decrease) increase in short-term debt	$ (169,012)	$
Long-term debt payments	(10,250)	
Stock options exercised	7,981	
Proceeds from sale of treasury stock	24,366	
Purchase of treasury stock--net	(74,631)	
Distributions (to) and contributions from minority interest	(91)	
Cash dividends paid	(65,445)	
Net cash (used in) provided by financing activities	(287,082)	
Exchange rate effect on cash and cash equivalents	(2,573)	
NET INCREASE IN CASH AND CASH EQUIVALENTS	105,462	
Cash and cash equivalents at beginning of year	63,384	

Cash and cash equivalents at end of year	$ 168,846	$
Supplemental Cash Flow Information		
Cash payments for interest	$ 10,501	$
Cash payments for taxes	154,228	
Noncash Investing Activities:		
Fair value of noncash assets acquired in business acquisition	$ 17,175	$
Liabilities assumed in business acquisition	(2,768)	
Increase (decrease) in fair value of investment securities, net of tax effect	4,736	
Investment in unconsolidated entity	--	

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

W.W. Grainger, Inc., and Subsidiaries

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(In thousands of dollars except for per share amounts)

	Common Stock	Additional Contributed Capital	Retained Earnings	Unearned Restricted Stock Compensation	A C E
Balance at January 1, 1999........	$53,617	$249,482	$1,585,344	$ (17,238)	
Exercise of stock options.........	97	4,411	--	--	
Issuance of 42,000 shares of restricted common stock......	21	1,880	--	(1,901)	
Cancellation of 10,000 shares of restricted common stock......	(5)	(375)	--	380	
Amortization of unearned restricted stock compensation...	--	139	--	2,178	
Purchase of 355,300 shares of treasury stock, net of 4,680 shares issued	--	32	--	--	
Cumulative translation adjustments	--	--	--	--	
Unrealized holding gain on investments, net of tax......	--	--	--	--	
Net earnings......................	--	--	180,731	--	
Cash dividends paid ($0.63 per share)..............	--	--	(58,817)	--	
Balance at December 31, 1999......	53,730	255,569	1,707,258	(16,581)	
Exercise of stock options.........	140	8,859	--	--	
Issuance of 367,500 shares of restricted common stock......	182	15,145	--	(15,450)	
Cancellation of 70,500 shares of restricted common stock......	(35)	(2,975)	--	3,010	
Amortization of unearned restricted stock compensation...	--	210	--	6,301	
Purchase of 31,400 shares of treasury stock, net of 6,440 shares issued	--	11	--	--	
Cumulative translation adjustments	--	--	--	--	

Unrealized holding (loss) on investments, net of tax......	--	--	--	--
Reclassification adjustments for realized gains included in net earnings..	--	--	--	--
Net earnings.....................	--	--	192,903	--
Cash dividends paid ($0.67 per share)..............	--	--	(62,863)	--
Balance at December 31, 2000......	54,017	276,819	1,837,298	(22,720)
Exercise of stock options.........	166	9,476	--	--
Issuance of 247,275 shares of restricted common stock, net of 24,835 shares retained...	111	5,006	--	(8,760)
Cancellation of 114,655 shares of restricted common stock.........	(57)	(2,785)	--	4,842
Issuance of 787,020 shares of treasury stock	--	(72)	(8,411)	--
Remeasurement of restricted stock.	--	526	--	--
Amortization of unearned restricted stock compensation...	--	263	--	8,916
Purchase of 1,820,000 shares of treasury stock, net of 8,130 shares issued	--	(32)	--	--
Cumulative translation adjustments	--	--	--	--
Unrealized holding gain on investments, net of tax.........	--	--	--	--
Reclassification adjustments for realized gains included in net earnings..	--	--	--	--
Net earnings.....................	--	--	174,530	--
Cash dividends paid ($0.695 per share).............	--	--	(65,445)	--
Balance at December 31, 2001......	$54,237	$289,201	$1,937,972	$ (17,722)

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

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W.W. Grainger, Inc., and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2001, 2000, and 1999

NOTE 1--SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

INDUSTRY INFORMATION

The Company is engaged in the distribution of maintenance, repair, and operating (MRO) supplies, services, and related information to businesses and institutions in North America.

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 percent to 50 percent of the voting shares, the equity method of accounting is used. The Company also accounts for investments below 20 percent using the equity method when significant influence over operating and financial policies of the investee company can be exercised for those investments. (See Note 7 to the Consolidated Financial Statements.)

RECLASSIFICATIONS

Certain amounts in the 2000 and 1999 financial statements, as previously reported, have been reclassified to conform to the 2001 presentation.

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 assets and 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 generally 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, except for those from highly inflationary economies, are recorded as a separate component of shareholders equity.

INVENTORIES

Inventories are valued at the lower of cost or market. Cost is determined primarily by the last-in, first-out (LIFO) method. For non-LIFO inventories, cost is determined by the first-in, first-out (FIFO) method.

COST OF MERCHANDISE SOLD

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

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 used in 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 $1,323,000, $747,000, and $3,238,000, in 2001, 2000, and 1999, respectively.

LONG-LIVED ASSETS

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If the fair value of an asset is determined to be less than the carrying amount of the asset, a loss is recognized for the difference.

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 on the date products are shipped. Fee revenues are recognized on the date services are completed.

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.

PURCHASED TAX BENEFITS

The Company purchased tax benefits through leases as provided by the Economic Recovery Tax Act of 1981. Realized tax benefits, net of repayments, are included in Deferred Income Taxes.

OTHER COMPREHENSIVE EARNINGS

The Company s other comprehensive earnings include unrealized gains on investments, net of tax, and foreign currency translation adjustments with no related income tax effects. The cumulative amount of other comprehensive (loss) earnings was $(29,553,000), $(18,832,000), and $68,791,000, at December 31, 2001, 2000, and 1999, respectively.

ADOPTION OF ACCOUNTING STANDARD

The Company adopted Statement of Financial Accounting Standards (SFAS) No. 133, Accounting for Certain Derivative Instruments and Hedging Activities, effective January 1, 2001. The Company uses non-derivative financial instruments to help hedge its exposure for certain investments in foreign subsidiaries in which the net assets are exposed to currency exchange rate volatility. Adoption of SFAS No. 133 requires the Company to report the net amounts of gains and losses that arise from qualifying non-derivative hedging instruments in the cumulative translation adjustment during the reporting period. The Company s accounting treatment of SFAS No. 133 is consistent with the method it previously used under SFAS No. 52, Foreign Currency Translation.

Currency exposure related to the Company s investment in the net assets of its Canadian subsidiary, Acklands-Grainger Inc. (AGI), is partially mitigated by a foreign currency denominated debt obligation of the parent. Gains and losses associated with the debt obligation offset gains and losses in the net investment in AGI.

The amount of gain (loss) related to the foreign currency denominated debt obligation for the years ended December 31, 2001, 2000, and 1999 was $7,039,000, $4,550,000, and $(7,028,000), respectively, and were included in accumulated other comprehensive earnings.

NEW ACCOUNTING PRONOUNCEMENTS

On July 20, 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 141, Business Combinations, and SFAS No. 142, Goodwill and Intangible Assets. SFAS No. 141 is effective for all business combinations completed after June 30, 2001. SFAS No. 142 is effective for fiscal years beginning after December 15, 2001; however, certain provisions of this Statement apply to goodwill and other intangible assets acquired between July 1, 2001, and the effective date of SFAS No. 142. Major provisions of these Statements and their effective dates for the Company are as follows:

1. All business combinations initiated after June 30, 2001 must use the purchase method of accounting. The pooling of interest method of accounting is prohibited except for transactions initiated before July 1, 2001.
2. Intangible assets acquired in a business combination must be recorded separately from goodwill if they arise from contractual or other legal rights or are separable from the acquired entity and can be sold, transferred, licensed, rented, or exchanged, either individually or as part of a related contract, asset, or liability.
3. Goodwill and other intangible assets with indefinite lives, acquired after June 30, 2001, are not amortized. Effective January 1, 2002, all previously recognized goodwill and intangible assets with indefinite lives will no longer be subject to amortization.
4. Effective January 1, 2002, goodwill and intangible assets with indefinite lives will be tested for impairment annually and whenever there is an impairment indicated.
5. All acquired goodwill must be assigned to reporting units for purposes of impairment testing and segment reporting.

At December 31, 2001, goodwill had a net carrying value of $150 million. In 2001, amortization expense for goodwill was $3,192,000 after-tax, or $0.03 per share. The Company is currently evaluating the classification of other intangibles and the effect of impairment provisions of SFAS No. 142 and is in the process of assessing the impact of adoption on its consolidated financial statements.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001, and addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This statement supersedes SFAS No. 121 Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, and the accounting and reporting provisions of Accounting Principles Board Opinion No. 30, Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, for the disposal of a segment of a business. The Company plans to adopt SFAS No. 144 at January 1, 2002, and has determined that adoption will not have a material effect on its results of operations or financial position.

NOTE 2--BUSINESS ACQUISITION

On February 26, 2001, Lab Safety Supply, Inc., the Company s wholly owned subsidiary, acquired The Ben Meadows Co., Inc. (Ben Meadows), of Canton, Georgia, for approximately $14.4 million, including costs associated with the acquisition.

Ben Meadows, a privately held corporation with annual sales of $20,000,000, is a business-to-business direct marketer specializing in equipment and supplies for the environmental and forestry management markets. The acquisition was accounted for under the purchase method of accounting. Results for Ben Meadows are included in the Company s results since the date of its acquisition. Given the size of the acquisition, pro forma disclosures are not considered necessary.

NOTE 3--NON-RECURRING CHARGES

On April 23, 2001, the Company announced its plans to shut down the operations of Material Logic and write down its investment in other digital activities. Material Logic was the business unit the Company formed to seek other equity participants in developing several digital operations. As a result of this action, the Company shut down all of Material Logic s branded e-commerce sites except FindMRO, which remains an integrated sourcing service for the Company s customers.

In connection with the closing of Material Logic, the Company took a non-recurring, pretax charge of $39.1 million (after-tax $23.2 million) in 2001. The Company provided a comprehensive separation package, including outplacement services, to the employees whose jobs were eliminated. As part of the shutdown, 166 employees were severed. Severance payments began in July 2001 and will continue until June 2004, when the last severance package expires.

In addition, the Company wrote down its investment in other digital enterprises and took a pretax charge of $25.1 million (after-tax $13.4 million). This included the loss on the divestiture of the Company s 40% investment in Works.com, Inc. The Company acquired its ownership in Works.com, Inc., an unrelated third party, on August 1, 2000, when the Company s OrderZone.com business unit was combined with Works.com.

The total effect of these non-recurring charges amounted to an after-tax cost of $36.6 million, or $0.39 per share.

The following table displays the activity and balance of the Material Logic restructuring reserve as of December 31, 2001:

	Original Provision	Deductions	Adjustment
		(In thousands of dollars)	
Restructuring Reserve (Operating expenses):			
Workforce reductions	$ 17,200	$ (9,264)	$ (3,056)
Asset and equipment write-offs and disposals	5,800	(4,277)	(587)
Contractual obligations	5,000	(7,482)	2,482
Other shutdown costs	12,000	(8,570)	231
	$ 40,000	$(29,593)	$ (930)

Deductions reflect cash payments of $17,597,000 and noncash charges of $11,996,000. The amounts in the adjustments column are reclassifications and reductions to reflect management s current estimate of costs, by expense category.

NOTE 4--CASH FLOWS

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.

NOTE 5--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 as well as other areas of North America. Consequently, no significant concentration of credit risk is considered to exist.

NOTE 6--INVENTORIES

Inventories primarily consist of merchandise purchased for resale.

Inventories would have been $202,390,000, $211,801,000, and $211,490,000, higher than reported at December 31, 2001, 2000, and 1999, respectively, if the first-in, first-out (FIFO) method of inventory accounting had been used for all Company inventories. Net earnings would have (decreased) increased by $(5,741,000), $188,000, and $(3,603,000), for the years ended December 31, 2001, 2000, and 1999, respectively, using the FIFO method OM>

55,212

Excess tax benefit from stock based payments

7,280

Purchase of common stock

Net cash used in financing activities	(1,307,911)	(1,204,692)
EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH	6,200	(98,177)

NET DECREASE IN CASH AND CASH EQUIVALENTS

(1,162,393

)

(9,408,734

)

CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD

16,787,558

21,293,448

CASH AND CASH EQUIVALENTS AT END OF PERIOD

$

15,625,165

$

11,884,714

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Income taxes paid	$ 275,522	$ 260,893
Interest paid	46,290	52,731
Dividends declared not paid	1,264,122	1,170,058

The accompanying notes are an integral part of the condensed consolidated financial statements.

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COMMUNICATIONS SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of business

Communications Systems, Inc. (herein collectively called CSI or the Company) is a Minnesota corporation organized in 1969 which operates directly and through its subsidiaries located in the United States, Costa Rica, the United Kingdom and China. CSI is principally engaged through its Suttle and Austin Taylor business units in the manufacture and sale of modular connecting and wiring devices for voice and data communications, digital subscriber line filters, and structured wiring systems and through its Transition Networks business unit in the manufacture of media and rate conversion products for telecommunications networks. CSI also provides through its JDL Technologies (JDL) business unit IT solutions including network design, computer infrastructure installations, IT service management, change management, network security and network operations services.

Financial statement presentation

The condensed consolidated balance sheets and consolidated statement of changes in stockholders equity as of March 31, 2011 and 2010 and the related consolidated statements of income and comprehensive income (loss), and the condensed consolidated statements of cash flows for the periods ended March 31, 2011 and 2010 have been prepared by Company management. In the opinion of management, all adjustments (which include only normal recurring adjustments except where noted) necessary to present fairly the financial position, results of operations, and cash flows at March 31, 2011 and 2010 and for the periods then ended have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted. We recommend these condensed consolidated financial statements be read in conjunction with the financial statements and notes thereto included in the Company s December 31, 2010 Annual Report to Shareholders on Form 10-K. The results of operations for the periods ended March 31 are not necessarily indicative of operating results for the entire year.

The presentation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosure of contingent assets and liabilities at the balance sheet date, and the reported amounts of revenues and expenses during the reporting period. The estimates and assumptions used in the accompanying condensed consolidated financial statements are based upon management s evaluation of the relevant facts and circumstances as of the time of the financial statements. Actual results could differ from those estimates.

Except to the extent updated or described below, the significant accounting policies set forth in Note 1 to the consolidated financial statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2010, appropriately represent, in all material respects, the current status of accounting policies, and are incorporated herein by reference.

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Cash equivalents and investments

For purposes of the condensed consolidated balance sheet and statements of cash flows, the Company considers all highly liquid investments with an original maturity of three months or less at the time of purchase to be cash equivalents. As of March 31, 2011, the Company had $15.6 million in cash and cash equivalents. Of this amount, $8.9 million was invested in short-term money market funds that are not considered to be bank deposits and are not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC) or other government agency. These money market funds seek to preserve the value of the investment at $1.00 per share; however, it is possible to lose money investing in these funds.

The remainder of the Company s cash and cash equivalents is deposited at banks. The FDIC insures deposits at banks up to $250,000 per account. The Company s cash and cash equivalents are held at large, well-established financial institutions and the Company believes any risk associated with uninsured balances is remote.

The Company had $26.0 million in investments, which consist of certificates of deposit that were purchased in the public markets and are classified as available-for-sale at March 31, 2011. Of the $26.0 million in investments, $19.9 million mature in 12 months or less and are classified as current assets. Available-for-sale investments are reported at fair value with unrealized gains and losses net of tax excluded from operations and reported as a separate component of stockholders equity (See Comprehensive income below).

Revenue Recognition

The Company s manufacturing operations (Suttle, Transition Networks and Austin Taylor) recognize revenue when the earnings process is complete, evidenced by persuasive evidence of an agreement, delivery has occurred or services have been rendered, the price is fixed or determinable, and collectability is reasonably assured. Revenue is recognized for domestic and international sales at the shipping point or delivery to customers, based on the related shipping terms. Risk of loss transfers at the point of shipment or delivery to customers, and the Company has no further obligation after this time. Sales are made directly to customers and through distributors. Payment terms for distributors are consistent with the terms of the Company s direct customers. The Company records a provision for sales returns, sales incentives and warranty costs at the time of the sale based on historical experience and current trends.

JDL generally records revenue on hardware, software and related equipment sales and installation contracts when the revenue recognition criteria are met and products are installed and accepted by the customer. JDL records revenue on service contracts on a straight-line basis over the contract period, unless evidence suggests the revenue is earned in a different pattern. Each contract is individually reviewed to determine when the earnings process is complete.

Accumulated other comprehensive income (loss)

The components of accumulated other comprehensive income (loss), net of tax, are as follows:

	March 31 2011	December 31 2010
Foreign currency translation	$ (1,204,473)	$ (1,272,530)
Unrealized gain (loss) on available-for-sale investments	(1,270)	14,058
Minimum pension liability	963,617	972,835
	$ (242,126)	$ (285,637)

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NOTE 2 - STOCK-BASED COMPENSATION

Employee Stock Purchase Plan

Under the Company s Employee Stock Purchase Plan (ESPP) employees are able to acquire shares of common stock at 95% of the price at the end of the current quarterly plan term, which is March 31, 2011. The ESPP is non-compensatory under current rules and does not give rise to compensation cost. At March 31, 2011, 75,131 shares remain available for purchase under the ESPP.

Stock Option Plan for Directors

Shares of common stock are also reserved for issuance in connection with a nonqualified stock option plan under which shares may be issued to nonemployee directors (the Director Plan). The Director Plan provides for the automatic grant of nonqualified options for 3,000 shares of common stock annually to each nonemployee director concurrent with the annual shareholders meeting. Exercise price is the fair market value of the stock at the date of grant. Options granted under the Director Plan vest when issued and expire 10 years from date of grant. At March 31, 2011, 37,000 shares are available to be issued under the Director Plan.

Stock Plan

Under the Company s 1992 Stock Plan (the Stock Plan) shares of common stock may be issued pursuant to stock options, restricted stock or deferred stock grants to officers and key employees. Exercise prices of stock options under the Stock Plan cannot be less than fair market value of the stock on the date of grant. Rules and conditions governing awards of stock options, restricted stock and deferred stock are determined by the Compensation Committee of the Board of Directors, subject to certain limitations in the Stock Plan.

During the quarter ending March 31, 2011 stock options were awarded covering 89,610 shares to key executive employees, which options expire seven years from the date of award and vest 25% each year beginning one year after the date of award.

During the quarter ended March 31, 2011, key employees were granted 16,092 shares of deferred stock based on achievement against performance goals in 2010 under the Company s performance unit plan. The deferred stock will be paid out in the first quarter of 2014 to key employees still with the Company at that time. The Company also granted deferred stock awards of 73,972 shares to key employees under the Company s performance unit plan for performance over the 2011 to 2013 period. The actual number of shares of deferred stock earned by the respective employees, if any, will be determined based on achievement against cumulative performance goals for the three years ending December 31, 2013 and the number of shares earned will be paid in the first quarter of 2014 to those key employees still with the Company at that time. During the first quarter, the Company also granted deferred stock awards of up to 11,618 shares to executive employees that will be earned under the Company s short-term incentive plan if actual revenue growth equals or exceeds 150% of the revenue growth target for 2011. The number of shares earned by the respective executive employees, if any, will be paid out in the first quarter of 2012.

At March 31, 2011, 933,981 shares remained available to be issued under the Stock Plan.

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Changes in Stock Options Outstanding

The following table summarizes changes in the number of outstanding stock options under the Director Plan and Stock Plan over the period December 31, 2010 to March 31, 2011. All stock options outstanding at December 31, 2010 are exercisable and none of the options awarded during the period ended March 31, 2011 are exercisable.

		Options	Weighted average exercise price per share	Weighted average remaining contractual term
Outstanding	December 31, 2010	162,000	$ 9.49	5.33 years
Awarded		89,610	14.15	
Exercised		(3,000)	8.10	
Canceled				
Outstanding	March 31, 2011	248,610	11.19	5.65 years

The aggregate intrinsic value of all options (the amount by which the market price of the stock on the last day of the period exceeded the market price of the stock on the date of grant) outstanding at March 31, 2011 was $1,045,000. The intrinsic value of all options exercised during the three months ended March 31, 2011 was $19,000. Net cash proceeds from the exercise of all stock options were $24,000 and $0 for the three months ended March 31, 2011 and 2010, respectively.

Compensation Expense

Share based compensation expense recognized for the three month period ended March 31, 2011 was $80,000 before income taxes and $52,000 after income taxes. No stock compensation expense was recognized for the three month period ended March 31, 2010. Unrecognized compensation expense for the Company s plans was $857,000 at March 31, 2011. Excess tax benefits from the exercise of stock options included in financing cash flows for the three month periods ended March 31, 2011 and 2010 were $7,000 and $0, respectively.

NOTE 3 - INVENTORIES

Inventories summarized below are priced at the lower of first-in, first-out cost or market:

	March 31 2011	December 31 2010
Finished goods	$ 13,616,894	$ 13,684,884
Raw and processed materials	11,392,455	10,814,051
Total	$ 25,009,349	$ 24,498,935

NOTE 4 WARRANTY

We provide reserves for the estimated cost of product warranties at the time revenue is recognized. We estimate the costs of our warranty obligations based on our warranty policy or applicable contractual warranty, historical experience of known product failure rates, and use of materials and service delivery costs incurred in correcting product failures. Management reviews the estimated warranty liability on a quarterly basis to determine its adequacy. The actual warranty expense could differ from the estimates made by the Company based on product performance.

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The following table presents the changes in the Company s warranty liability for the three month periods ended March 31, 2011 and 2010, respectively, the majority of which relates to a five-year obligation to provide for potential future liabilities for network equipment sales.

	2011	2010
Beginning Balance	$ 616,000	$ 648,000
Actual warranty costs paid	(89,000)	(18,000)
Amounts charged to expense	105,000	(50,000)
Ending balance	$ 632,000	$ 580,000

NOTE 5 CONTINGENCIES

In the ordinary course of business, the Company is exposed to legal actions and claims and incurs costs to defend against these actions and claims. Company management is not aware of any outstanding or pending legal actions or claims that would materially affect the Company s financial position or results of operations.

NOTE 6 INCOME TAXES

In the preparation of the Company s consolidated financial statements, management calculates income taxes based upon the estimated effective rate applicable to operating results for the full fiscal year. This includes estimating the current tax liability as well as assessing differences resulting from different treatment of items for tax and book accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. These assets and liabilities are analyzed regularly and management assesses the likelihood that deferred tax assets will be recovered from future taxable income.

At March 31, 2011 there was $546,000 of net uncertain tax benefit positions that would reduce the effective income tax rate if recognized. The Company records interest and penalties related to income taxes as income tax expense in the Condensed Consolidated Statements of Income.

The Company is subject to U.S. federal income tax as well as income tax of multiple state and foreign jurisdictions. The tax years 2007-2009 remain open to examination by the Internal Revenue Service and the years 2006-2009 remain open to examination by various state tax departments. The tax years from 2008-2009 remain open in Costa Rica.

The Company s effective income tax rate was 38.5% for the first three months of 2011. The effective tax rate differs from the federal tax rate of 35% due to state income taxes, foreign losses not deductible for U.S. income tax purposes, provisions for interest charges and settlement of uncertain income tax positions. The foreign operating losses may ultimately be deductible in the countries in which they have occurred; however the Company has not recorded a deferred tax asset for these losses due to uncertainty regarding the eventual realization of the benefit. The effect of the foreign operations is an overall rate increase of approximately 0.4% for the three months ended March 31, 2011. There were no additional uncertain tax positions identified in the first quarter of 2011. The Company s effective income tax rate for the three months ended March 31, 2010 was 37%, and differed from the federal tax rate due to state income taxes, foreign losses not deductible for U.S. income tax purposes, provisions for interest charges, and settlement of uncertain tax positions.

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NOTE 7 SEGMENT INFORMATION

The Company classifies its businesses into four segments as follows:

- Suttle manufactures and sells U.S. standard modular connecting and wiring devices for voice and data communications, digital subscriber line filters, and structured wiring systems;
- Transition Networks designs and markets data transmission, computer network and media conversion products;
- JDL Technologies, Inc. provides IT services including network design, computer infrastructure installations, IT service management, change management, network security and network operations services;
- Austin Taylor Communications LTD manufactures British-standard telephone equipment and equipment enclosures for the U.K and international markets.

Our non-allocated corporate general and administrative expenses are categorized as Other in the Company s segment reporting. Management has chosen to organize the enterprise and disclose reportable segments based on our products and services. There are no material inter-segment revenues.

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Information concerning the Company s continuing operations in the various segments for the three month periods ended March 31, 2011 and 2010 is as follows:

SEGMENT INFORMATION

	Suttle	Transition Networks	JDL Technologies	Austin Taylor	Other	Total
Three months ended March 31, 2011:						
Sales	$ 9,659,974	$ 16,555,896	$ 3,779,724	$ 1,027,208		$ 31,022,802
Cost of sales	7,126,170	7,579,227	2,152,368	836,548		$ 17,694,313
Gross profit	2,533,804	8,976,669	1,627,356	190,660		13,328,489
Selling, general and administrative expenses	1,816,945	5,332,393	512,820	303,246	1,221,806	$ 9,187,210
Operating income (loss)	$ 716,859	$ 3,644,276	$ 1,114,536	$ (112,586)	$ (1,221,806)	$ 4,141,279
Depreciation and amortization	$ 217,016	$ 167,154	$ 28,488	$ 11,898	$ 74,665	$ 499,221
Capital expenditures	$ 232,625	$ 191,550	$ 10,051	$ 9,376	$	$ 443,602
Assets at March 31, 2011	$ 20,424,181	$ 32,125,732	$ 3,668,604	$ 2,732,972	$ 51,366,484	$ 110,317,973

	Suttle	Transition Networks	JDL Technologies	Austin Taylor	Other	Total
Three months ended March 31, 2010:						
Sales	$ 9,927,105	$ 13,753,196	$ 1,295,719	$ 905,991	$	$ 25,882,011
Cost of sales	7,276,458	6,330,882	934,898	824,712		$ 15,366,950
Gross profit	2,650,647	7,422,314	360,821	81,279		10,515,061
Selling, general and administrative expenses	1,787,899	4,893,304	387,196	248,554	1,077,843	$ 8,394,796
Operating income (loss)	$ 862,748	$ 2,529,010	$ (26,375)	$ (167,275)	$ (1,077,843)	$ 2,120,265
Depreciation and amortization	$ 217,037	$ 147,023	$ 37,919	$ 12,202	$ 72,510	$ 486,692
Capital expenditures	$ 463,796	$ 26,590	$ 11,787	$ 14,648	$ 38,787	$ 555,608
Assets at March 31, 2010	$ 20,160,161	$ 30,071,446	$ 2,540,094	$ 3,890,113	$ 45,177,607	$ 101,839,421

NOTE 8 PENSIONS

The Company s U.K. based subsidiary Austin Taylor maintains defined benefit pension plans that cover approximately seven active employees. The Company does not provide any other post-retirement benefits to its employees. Components of net periodic benefit cost of the pension plans were:

	Three months Ended March 31 2011	2010
Service cost	$ 12,000	9,000
Interest cost	67,000	62,000
Expected return on plan assets	(63,000)	(54,000)
	$ 16,000	$ 17,000

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NOTE 9 NET INCOME PER SHARE

Basic net income per common share is based on the weighted average number of common shares outstanding during each year. Diluted net income per common share takes into effect the dilutive effect of potential common shares outstanding. The Company s only potential common shares outstanding are stock options and shares associated with the long-term incentive compensation plans, which resulted in a dilutive effect of 44,841 shares and 31,605 shares for the respective three month periods ended March 31, 2011 and 2010. The Company calculates the dilutive effect of outstanding options using the treasury stock method. The number of shares not included in the computation of diluted earnings per share was 0 and 24,000 at March 31, 2011 and 2010, respectively. Certain options were not included because the exercise price was greater than the average market price of common stock during the period and certain deferred stock awards were not included because of unmet performance conditions.

NOTE 10 FAIR VALUE MEASUREMENTS

The accounting guidance establishes a valuation hierarchy for disclosure of the inputs to valuation used to measure fair value. This hierarchy prioritizes the inputs into three broad levels as follows:

Level 1 Observable inputs that reflect unadjusted quoted prices for identical assets or liabilities in active markets that the Company has the ability to access at the measurement date.

Level 2 Observable inputs such as quoted prices for similar instruments and quoted prices in markets that are not active, and inputs that are directly observable or can be corroborated by observable market data. The types of assets and liabilities included in Level 2 are typically either comparable to actively traded securities or contracts, such as treasury securities with pricing interpolated from recent trades of similar securities, or priced with models using highly observable inputs, such as commodity options priced using observable forward prices and volatilities.

Level 3 Significant inputs to pricing have little or no observability as of the reporting date. The types of assets and liabilities included in Level 3 are those with inputs requiring significant management judgment or estimation, such as the complex and subjective models and forecasts used to determine the fair value of financial instruments.

The Company s assets and liabilities that are measured at fair value on a recurring basis as of March 31, 2011 and December 31, 2010, respectively, include money market funds within cash and cash equivalents of $8,901,000 and $9,624,000 classified as Level 1 within the hierarchy and certificate of deposits within investments of $26,048,000 and $26,287,000 classified as Level 2. The Company does not have any assets or liabilities classified as Level 3 within the hierarchy. There were no transfers between levels during the three months ended March 31, 2011.

NOTE 11 SUBSEQUENT EVENTS

The Company has evaluated subsequent events through the date of this filing. We do not believe there are any material subsequent events that would require further disclosure.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

Forward looking statements

In this report and, from time to time, in reports filed with the Securities and Exchange Commission, in press releases, and in other communications to shareholders or the investing public, the Company may make forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 concerning possible or anticipated future financial performance, business activities, plans, pending claims, investigations or litigation which are typically preceded by the words believes, expects, anticipates, intends or similar expressions. For these forward-looking statements, the Company claims the protection of the safe harbor for forward-looking statements contained in federal securities laws. Shareholders and the investing public should understand that these forward looking statements are subject to risks and uncertainties that could cause actual performance, activities, anticipated results, outcomes or plans to differ significantly from those indicated in the forward-looking statements. These risks and uncertainties include, but are not limited to:

- our ability to manufacture and deliver our products to customers in the time frame these customers have specified;
- lower sales to major telephone companies and other major customers;
- the introduction of competitive products and technologies;
- our ability to successfully reduce operating expenses at certain business units;
- the general health of the telecom sector;
- the continuing economic downturn and the fact that conditions outside the United States are recovering more slowly than within the United States;
- successful integration and profitability of acquisitions;
- delays in new product introductions;
- higher than expected expense related to new sales and marketing initiatives;
- unfavorable resolution of claims and litigation;
- availability of adequate supplies of raw materials and components;
- fuel prices;
- government funding of education technology spending; and
- other factors discussed from time to time in the Company s filings with the Securities and Exchange Commission, including risk factors presented under Item 1A of the Company s most recently filed annual report on Form 10-K.

Three Months Ended March 31, 2011 Compared to
Three Months Ended March 31, 2010

Consolidated sales increased 20% in 2011 to $31,023,000 compared to $25,882,000 in 2010. Consolidated operating income in 2011 increased to $4,141,000 compared to $2,120,000 in the first quarter of 2010.

Net income in 2011 increased to $2,558,000 compared to $1,331,000 in the first quarter of 2010.

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Suttle

Suttle sales decreased 3% in the first quarter of 2011 to $9,660,000 compared to $9,927,000 in the same period of 2010 due to a continued decline in the voice markets. Sales by customer groups in the first quarter of 2011 and 2010 were:

	Suttle Sales by Customer Group	
	2011	**2010**
Major telephone companies	$ 6,875,000	$ 6,751,000
Distributors	1,149,000	1,458,000
International	1,391,000	1,682,000
Other	245,000	36,000
	$ 9,660,000	$ 9,927,000

Suttle s sales by product groups in first quarter of 2011 and 2010 were:

	Suttle Sales by Product Group	
	2011	**2010**
Modular connecting products	$ 3,551,000	$ 4,213,000
DSL products	2,959,000	3,070,000
Structured cabling products	2,918,000	2,490,000
Other products	232,000	154,000
	$ 9,660,000	$ 9,927,000

Sales to the major telephone companies increased 2% in 2011 due to an increase in new multi-dwelling unit construction within the US housing market, which is offset by declines in sales of DSL products and a continued decline in voice markets. Sales to these customers accounted for 71% of Suttle s sales in the first quarter of 2011 compared to 68% of sales in 2010. Sales to distributors decreased 21% in 2011 due to continued declines in voice markets, and continued challenges in the single family unit construction within the US housing market. This customer segment accounted for 12% and 15% of sales in the first quarters of 2011 and 2010, respectively. International sales decreased 17% and accounted for 14% of Suttle s first quarter 2011 sales. Suttle s products do not have a large international market due to different product specifications in non-U.S. markets.

Modular connecting products sales have decreased 16% due to continued decline in the voice market. Sales of DSL products decreased 4% due to the maturation of the U.S. DSL market and the order cycle of major customers. Sales of structured cabling products increased 17% due to an increase in new multi-dwelling unit construction market.

Suttle s gross margin decreased 4% in the first quarter of 2011 to $2,534,000 compared to $2,651,000 in the same period of 2010. Gross margin as a percentage of sales decreased to 26% in 2011 from 27% in 2010 due to product mix changes. Selling, general and administrative expenses increased $29,000 or 2% in the first quarter of 2011 compared to the same period in 2010, due to increased spending in the Company s technology development initiative. Suttle s operating income was $717,000 in the first quarter of 2011 compared to operating income of $863,000 in 2010.

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Transition Networks

Transition Networks sales increased 20% to $16,556,000 in the first quarter of 2011 compared to $13,753,000 in 2010.

First quarter sales by region are presented in the following table:

	Transition Networks Sales by Region			
		2011		2010
North America	$	13,218,000	$	11,095,000

Optionee means the person so designated in an agreement evidencing an outstanding Option Right.

Option Price means the purchase price payable upon the exercise of an Option Right.

Option Right means the right to purchase Common Shares upon exercise of an option granted pursuant to Section 4 or Section 9 of this Plan.

Participant means a person who is selected by the Committee to receive benefits under this Plan and who is at that time an officer, including without limitation an officer who may also be a member of the Board, or other key employee of the Corporation or any Subsidiary or who has agreed to commence serving in any such capacity, and shall also include each Nonemployee Director who receives an award pursuant to Section 9 of this Plan.

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Performance Period means, in respect of a Performance Share or Performance Unit, a period of time established pursuant to Section 8 of this Plan within which the Management Objectives relating thereto are to be achieved.

Performance Share means a bookkeeping entry that records the equivalent of one Common Share awarded pursuant to Section 8 of this Plan.

Performance Unit means a bookkeeping entry that records a unit equivalent to $100.00 awarded pursuant to Section 8 of this Plan.

Reload Option Rights means additional Option Rights granted automatically to an Optionee upon the exercise of Option Rights pursuant to Section 4(f) of this Plan.

Restricted Shares mean Common Shares granted or sold pursuant to Section 6 or Section 9 of this Plan as to which neither the substantial risk of forfeiture nor the restrictions on transfer referred to in Section 6 or Section 9 hereof has expired.

Rule 16b-3 means Rule 16b-3 of the Securities and Exchange Commission (or any successor rule to the same effect), as in effect from time to time.

Spread means, in the case of a Free-standing Appreciation Right, the amount by which the Market Value per Share on the date when any such right is exercised exceeds the Base Price specified in such right or, in the case of a Tandem Appreciation Right, the amount by which the Market Value per Share on the date when any such right is exercised exceeds the Option Price specified in the related Option Right.

Subsidiary means a corporation, partnership, joint venture, unincorporated association or other entity in which the Corporation has a direct or indirect ownership or other equity interest; provided, however, for purposes of determining whether any person may be a Participant for purposes of any grant of Incentive Stock Options, Subsidiary means any corporation in which the Corporation owns or controls directly or indirectly more than 50 percent of the total combined voting power represented by all classes of stock issued by such corporation at the time of such grant.

Tandem Appreciation Right means an Appreciation Right granted pursuant to Section 5 of this Plan that is granted in tandem with an Option Right or any similar right granted under any other plan of the Corporation.

3. Shares Available under the Plan. (a) Subject to adjustment as provided in Section 11 of this Plan, the maximum number of Common Shares issued or transferred (i) upon the exercise of Option Rights or Appreciation Rights, (ii) as Restricted Shares and released from all substantial risks of forfeiture, (iii) as Deferred Shares, (iv) in payment of Performance Shares or Performance Units that have been earned, (v) as automatic awards to Nonemployee Directors or (vi) in payment of dividend equivalents paid with respect to awards made under this Plan, shall not in the aggregate exceed 11,700,000 Common Shares, which may be Common Shares of original issuance or Common Shares held in treasury or a combination thereof; provided, however, that the number of Restricted Shares and Deferred Shares shall not (after taking any forfeitures into account and excluding all awards of Restricted Shares to Nonemployee Directors pursuant to Section 9 of this Plan) exceed 10% of such maximum, subject to adjustment as provided in Section 11 of this Plan. The 11,700,000 maximum number of Common Shares described in the preceding sentence consist of 2,800,000 Common Shares that were approved in 1992, 3,000,000 Common Shares that were approved in 1996, 3,000,000 Common Shares that were approved in 2000 and 2,900,000 Common Shares that are being added as of this Amendment and Restatement. The foregoing figures reflect adjustments for the 1997 stock split.

(b) Upon the full or partial payment of any Option Price by the transfer to the Corporation of Common Shares or upon satisfaction of tax withholding provisions in connection with any such

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exercise or any other payment made or benefit realized under this Plan by the transfer or relinquishment of Common Shares, there shall be deemed to have been issued or transferred under this Plan only the net number of Common Shares actually issued or transferred by the Corporation.

(c) Notwithstanding anything in this Plan to the contrary, the aggregate number of Common Shares actually issued or transferred by the Corporation upon the exercise of Incentive Stock Options shall not exceed the maximum number of Common Shares first specified above in Section 3(a), subject to adjustment as provided in Section 11 of this Plan.

(d) The number of Performance Units that may be granted and paid out under this Plan shall not in the aggregate exceed 150,000.

(e) Upon payment in cash of the benefit provided by any award granted under this Plan, any Common Shares that were covered by that award shall again be available for issuance or transfer hereunder.

(f) Notwithstanding any other provision of this Plan to the contrary, no Participant shall be granted Option Rights for more than 1,000,000 Common Shares during any period of five consecutive calendar years subject to adjustment as provided in Section 11 of this Plan.

(g) Notwithstanding any other provision of this Plan to the contrary, in no event shall any Participant in any period of one calendar year receive awards of Performance Shares and Performance Units having an aggregate value as of their respective Dates of Grant in excess of $2,000,000.

4. Option Rights. The Committee may from time to time authorize grants to Participants of options to purchase Common Shares upon such terms and conditions as the Committee may determine in accordance with the following provisions:

(a) Each grant shall specify the number of Common Shares to which it pertains, subject to the limitations set forth in Section 3 of this Plan.

(b) Each grant shall specify an Option Price per Common Share, which shall be equal to or greater than the Market Value per Share on the Date of Grant.

(c) Each grant shall specify the form of consideration to be paid in satisfaction of the Option Price and the manner of payment of such consideration, which may include (i) cash in the form of currency or check or other cash equivalent acceptable to the Corporation, (ii) nonforfeitable, unrestricted Common Shares, which are already owned by the Optionee and have a value at the time of exercise that is equal to the Option Price, (iii) any other legal consideration that the Committee may deem appropriate, including without limitation any form of consideration authorized under Section 4(d) below, on such basis as the Committee may determine in accordance with this Plan and (iv) any combination of the foregoing.

(d) Any grant may provide that payment of the Option Price may also be made in whole or in part in the form of Restricted Shares or other Common Shares that are subject to risk of forfeiture or restrictions on transfer. Unless otherwise determined by the Committee whenever any Option Price is paid in whole or in part by means of any of the forms of consideration specified in this Section 4(d), the Common Shares received by the Optionee upon the exercise of the Option Rights shall be subject to the same risks of forfeiture or restrictions on transfer as those that applied to the consideration surrendered by the Optionee; provided, however, that such risks of forfeiture and restrictions on transfer shall apply only to the same number of Common Shares received by the Optionee as applied to the forfeitable or restricted

Common Shares surrendered by the Optionee.

(e) Any grant may provide for deferred payment of the Option Price from the proceeds of sale through a bank or broker on the date of exercise of some or all of the Common Shares to which the exercise relates.

(f) Any grant may provide for the automatic grant to the Optionee of Reload Option Rights upon the exercise of Option Rights, including Reload Option Rights, for Common Shares or any other noncash consideration authorized under Sections 4(d) and (e) above.

(g) Successive grants may be made to the same Participant regardless of whether any Option Rights previously granted to such Participant remain unexercised.

(h) Each grant (other than an award to a Nonemployee Director pursuant to Section 9) shall specify the period or periods of continuous employment of the Optionee by the Corporation or any Subsidiary that are necessary before the Option Rights or installments thereof shall become exercisable, and any such grant may provide for the earlier exercisability of such rights in the event of retirement, death or disability of the Participant or a change in control of the Corporation or other similar transaction or event.

(i) Any grant of Option Rights may specify Management Objectives that must be achieved as a condition to the exercise of such rights.

(j) Option Rights granted under this Plan may be (i) options that are intended to qualify under particular provisions of the Code, including without limitation Incentive Stock Options, (ii) options that are not intended to so qualify or (iii) combinations of the foregoing.

(k) On or after the Date of Grant of any Option Rights other than Incentive Stock Options, the Committee may provide for the payment to the Optionee of dividend equivalents thereon in cash or Common Shares on a current, deferred or contingent basis. In the case of an Optionee who is, or is determined by the Committee to be likely to become, a covered employee within the meaning of Section 162(m) of the Code (or any successor provision), the payment will be contingent on the achievement of Management Objectives for a specified period. The payment of dividend equivalents also may be subject to additional conditions. In no event shall any such Optionee in any period of one calendar year earn dividend equivalents with a value in excess of $750,000.

(l) No Option Right granted under this Plan may be exercised more than 10 years from the Date of Grant.

(m) Each grant shall be evidenced by an Evidence of Award, which shall contain such terms and provisions as the Committee may determine consistent with this Plan.

5. Appreciation Rights. The Committee may also authorize grants to Participants of Appreciation Rights. An Appreciation Right shall be a right of the Participant to receive from the Corporation an amount, which shall be determined by the Committee and shall be expressed as a percentage (not exceeding 100 percent) of the Spread at the time of the exercise of such right. Any grant of Appreciation Rights under this Plan shall be upon such terms and conditions as the Committee may determine in accordance with the following provisions:

(a) Any grant may specify that the amount payable upon the exercise of an Appreciation Right may be paid by the Corporation in cash, Common Shares or any combination thereof and may (i) either grant to the Participant or reserve to the Committee the right to elect among those alternatives or (ii) preclude the right of the Participant to receive and the Corporation to issue Common Shares or other equity securities in

lieu of cash; provided, however, that no form of consideration or manner of payment that would cause Rule 16b-3 to cease to apply to this Plan shall be permitted.

(b) Any grant may specify that the amount payable upon the exercise of an Appreciation Right shall not exceed a maximum specified by the Committee on the Date of Grant.

(c) Any grant may specify (i) a waiting period or periods before Appreciation Rights shall become exercisable and (ii) permissible dates or periods on or during which Appreciation Rights shall be exercisable.

(d) Any grant may specify that an Appreciation Right may be exercised only in the event of retirement, death or disability of the Participant or a change in control of the Corporation or other similar transaction or event.

(e) Any grant may provide for the payment to the Participant of dividend equivalents thereon in cash or Common Shares on a current, deferred or contingent basis.

(f) Each grant shall be evidenced by an Evidence of Award, which shall describe the subject Appreciation Rights, identify any related Option Rights, state that the Appreciation Rights are subject to all of the terms and conditions of this Plan and contain such other terms and provisions as the Committee may determine consistent with this Plan.

(g) Any grant of Appreciation Rights may specify Management Objectives that must be achieved as a condition of the exercise of such rights.

(h) Regarding Tandem Appreciation Rights only: Each grant shall provide that a Tandem Appreciation Right may be exercised only (i) at a time when the related Option Right (or any similar right granted under any other plan of the Corporation) is also exercisable and the Spread is positive and (ii) by surrender of the related Option Right (or such other right) for cancellation.

(i) Regarding Free-standing Appreciation Rights only:

  (i) Each grant shall specify in respect of each Free-standing Appreciation Right a Base Price per Common Share, which shall be equal to or greater than the Market Value per Share on the Date of Grant;

  (ii) Successive grants may be made to the same Participant regardless of whether any Free-standing Appreciation Rights previously granted to such Participant remain unexercised;

  (iii) Each grant shall specify the period or periods of continuous employment of the Participant by the Corporation or any Subsidiary that are necessary before the Free-standing Appreciation Rights or installments thereof shall become exercisable, and any grant may provide for the earlier exercise of such rights in the event of retirement, death or disability of the Participant or a change in control of the Corporation or other similar transaction or event; and

  (iv) No Free-standing Appreciation Right granted under this Plan may be exercised more than 10 years from the Date of Grant.

6. Restricted Shares. The Committee may also authorize grants or sales to Participants of Restricted Shares upon such terms and conditions as the Committee may determine in accordance with the following provisions:

(a) Each grant or sale shall constitute an immediate transfer of the ownership of Common Shares to the Participant in consideration of the performance of services, entitling such Participant to dividend, voting and other ownership rights, subject to the substantial risk of forfeiture and restrictions on transfer hereinafter referred to.

(b) Each grant or sale may be made without additional consideration from the Participant or in consideration of a payment by the Participant that is less than the Market Value per Share on the Date of Grant.

(c) Each grant or sale shall provide that the Restricted Shares covered thereby shall be subject to a substantial risk of forfeiture within the meaning of Section 83 of the Code for a period of at least three years to be determined by the Committee on the Date of Grant, and any grant or sale may provide for the earlier termination of such period in the event of retirement, death or disability of the Participant or a change in control of the Corporation or other similar transaction or event; provided, however, that the Committee may authorize the grant or sale of Restricted Shares that are subject to such a risk of forfeiture for periods of less than three years in amounts that, when taken together with any Deferred Shares granted or sold on such terms pursuant to Section 7(c) of this Plan (after taking any forfeitures into account and excluding all awards of Restricted Shares to Nonemployee Directors pursuant to Section 9 of this Plan), in the aggregate do not exceed two percent of the maximum number of Common Shares specified in Section 3(a) above as being available for awards pursuant to this Plan.

(d) Each grant or sale shall provide that, during the period for which such substantial risk of forfeiture is to continue, the transferability of the Restricted Shares shall be prohibited or restricted in the manner and to the extent prescribed by the Committee on the Date of Grant. Such restrictions may include without limitation rights of repurchase or first refusal in the Corporation or provisions subjecting the Restricted Shares to a continuing substantial risk of forfeiture in the hands of any transferee.

(e) Any grant of Restricted Shares may specify Management Objectives which, if achieved, will result in termination or early termination of the restrictions applicable to such shares and each such grant shall specify in respect of such specified Management Objectives, a minimum acceptable level of achievement and shall set forth a formula for determining the number of Restricted Shares on which restrictions will terminate if performance is at or above the minimum level, but falls short of full achievement of the specified Management Objectives.

(f) Any grant or sale may require that any or all dividends or other distributions paid on the Restricted Shares during the period of such restrictions be automatically sequestered. Such distribution may be reinvested on an immediate or deferred basis in additional Common Shares, which may be subject to the same restrictions as the underlying award or such other restrictions as the Committee may determine.

(g) Each grant or sale shall be evidenced by an Evidence of Award, which shall contain such terms and provisions as the Committee may determine consistent with this Plan. Unless otherwise authorized or directed by the Committee, all certificates representing Restricted Shares, together with a stock power that shall be endorsed in blank by the Participant with respect to such shares, shall be held in custody by the Corporation until all restrictions thereon lapse.

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7. Deferred Shares. The Committee may also authorize grants or sales of Deferred Shares to Participants upon such terms and conditions as the Committee may determine in accordance with the following provisions:

(a) Each grant or sale shall constitute the agreement by the Corporation to issue or transfer Common Shares to the Participant in the future in consideration of the performance of services, subject to the fulfillment during the Deferral Period of such conditions as the Committee may specify.

(b) Each grant or sale may be made without additional consideration from the Participant or in consideration of a payment by the Participant that is less than the Market Value per Share on the Date of Grant.

(c) Each grant or sale shall provide that the Deferred Shares covered thereby shall be subject to a Deferral Period of at least three years, which shall be fixed by the Committee on the Date of Grant, and any grant or sale may provide for the earlier termination of such period in the event of retirement, death or disability of the Participant or a change in control of the Corporation or other similar transaction or event; provided, however, that the Committee may authorize the grant or sale of Shares that are subject to Deferral Periods of less than three years in amounts that, when taken together with any Restricted Shares granted or sold on such terms pursuant to Section 6(c) of this Plan (and after taking any forfeitures into account and excluding all awards of Restricted Shares to Nonemployee Directors pursuant to Section 9 of this Plan), in the aggregate do not exceed two percent of the maximum number of Common Shares specified in Section 3(a) above as being available for awards pursuant to this Plan.

(d) During the Deferral Period, the Participant shall not have any right to transfer any rights under the subject award, shall not have any rights of ownership in the Deferred Shares and shall not have any right to vote such shares, but the Committee may on or after the Date of Grant authorize the payment of dividend equivalents on such shares in cash or additional Common Shares on a current, deferred or contingent basis.

(e) Each grant or sale shall be evidenced by an Evidence of Award, which shall contain such terms and provisions as the Committee may determine consistent with this Plan.

8. Performance Shares and Performance Units. The Committee may also authorize grants to Participants of Performance Shares and Performance Units, which shall become payable to the Participant upon the achievement of specified Management Objectives, upon such terms and conditions as the Committee may determine in accordance with the following provisions:

(a) Each grant shall specify the number of Performance Shares or Performance Units to which it pertains, subject to the limitations in Section 3, which may be subject to adjustment to reflect changes in compensation or other factors.

(b) The Performance Period with respect to each Performance Share or Performance Unit shall be determined by the Committee on the Date of Grant and may be subject to earlier termination in the event of retirement, death or disability of the Participant or a change in control of the Corporation or other similar transaction or event.

(c) Each grant shall specify the Management Objectives that are to be achieved by the Participant and each grant shall specify in respect of the specified Management Objectives a minimum acceptable level of achievement below which no payment will be made and shall set forth a formula for determining the amount of any payment to be made if performance is at or above the minimum acceptable level but falls short of full achievement of the specified Management Objectives.

(d) Each grant shall specify the time and manner of payment of Performance Shares or Performance Units that shall have been earned, and any grant may specify that any such amount may be paid by the Corporation in cash, Common Shares or any combination thereof and may either grant to the Participant or reserve to the Committee the right to elect among those alternatives.

(e) Any grant of Performance Shares may specify that the amount payable with respect thereto may not exceed a maximum specified by the Committee on the Date of Grant. Any grant of Performance Units may specify that the amount payable, or the number of Common Shares issued, with respect thereto may not exceed maximums specified by the Committee on the Date of Grant.

(f) Any grant may provide for the payment to the Participant of dividend equivalents thereon in cash or in additional Common Shares on a current, deferred or contingent basis.

(g) Each grant of Performance Shares or Performance Units shall be evidenced by an Evidence of Award, which shall contain such terms and provisions as the Committee may determine consistent with this Plan.

9. Automatic Awards to Nonemployee Directors. Common Shares, Restricted Shares and Option Rights shall be automatically granted to Nonemployee Directors as follows:

(a) 2,000 Restricted Shares shall be granted to each Nonemployee Director who was not an employee of the Corporation or any Subsidiary at the time of his first election or appointment to the Board. Such Restricted Shares shall become transferable and nonforfeitable at the rate of 20 percent per year.

(b) 500 Common Shares shall be granted to each Nonemployee Director immediately following each annual meeting of shareholders thereafter for so long as he continues to be a Nonemployee Director. Such Common Shares shall be subject only to a restriction on transfer for a period of six months immediately following the Date of Grant thereof and shall bear a legend to the effect.

(c) An Option Right to purchase 3,000 Common Shares shall be granted to each Nonemployee Director immediately following each annual meeting of shareholders including the annual meeting at which such Nonemployee Director is first elected to the Board or the first annual meeting after appointment to the Board for so long as he continues to be a Nonemployee Director. The purchase price per Common Share for which each such Option Right is exercisable shall be a price equal to the closing price on the last trading day prior to the annual meeting as quoted on the New York Stock Exchange.

Each grant of Restricted Shares shall be evidenced by an Evidence of Award consisting of an award agreement in substantially the form of Exhibit A hereto and shall be subject to all of the terms and conditions set forth therein.

Each Option to purchase Common Shares shall be evidenced by an Evidence of Award consisting of an award agreement in substantially the form of Exhibit B hereto and shall be subject to all of the terms and conditions set forth therein.

10. Transferability. (a) No Option Right or other derivative security (as that term is used in Rule 16b-3) awarded under this Plan shall be transferable by a Participant other than by will or the laws of descent and distribution. Option Rights and Appreciation Rights shall be exercisable during a Participant s

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lifetime only by the Participant or, in the event of the Participant s legal incapacity, by his guardian or legal representative acting in a fiduciary capacity on behalf of the Participant under state law and court supervision. Notwithstanding the foregoing, the Committee, in its sole discretion, may provide for transferability of particular awards under this Plan.

(b) Any award made under this Plan may provide that all or any part of the Common Shares that are (i) to be issued or transferred by the Corporation upon the exercise of Option Rights or Appreciation Rights or upon the termination of the Deferral Period applicable to Deferred Shares, or in payment of Performance Shares or Performance Units or (ii) no longer subject to the substantial risk of forfeiture and restrictions on transfer referred to in Section 6 of this Plan, shall be subject to further restrictions upon transfer.

11. Adjustments. The Committee may make or provide for such adjustments in the (a) number of Common Shares covered by outstanding Option Rights, Appreciation Rights, Deferred Shares and Performance Shares granted hereunder, (b) prices per share applicable to such Option Rights and Appreciation Rights, and (c) kind of shares (including shares of another issuer) covered thereby, as the Committee in its sole discretion may in good faith determine to be equitably required in order to prevent dilution or enlargement of the rights of Participants that otherwise would result from (x) any stock dividend, stock split, combination of shares, recapitalization or other change in the capital structure of the Corporation, (y) any merger, consolidation, spin-off, spin-out, split-off, split-up, reorganization, partial or complete liquidation or other distribution of assets, issuance of rights or warrants to purchase securities or (z) any other corporate transaction or event having an effect similar to any of the foregoing. In the event of any such transaction or event, the Committee may provide in substitution for any or all outstanding awards under this Plan such alternative consideration as it may in good faith determine to be equitable under the circumstances and may require in connection therewith the surrender of all awards so replaced. Moreover, the Committee may on or after the Date of Grant provide in the agreement evidencing any award under this Plan that the holder of the award may elect to receive an equivalent award in respect of securities of the surviving entity of any merger, consolidation or other transaction or event having a similar effect, or the Committee may provide that the holder will automatically be entitled to receive such an equivalent award. The Committee may also make or provide for such adjustments in the numbers and kind of shares specified in Section 3, and in the number of Common Shares, Restricted Shares and Option Rights to be granted automatically pursuant to Section 9 of this Plan as the Committee in its sole discretion may in good faith determine to be appropriate in order to reflect any transaction or event described in this Section 11.

12. Fractional Shares. The Corporation shall not be required to issue any fractional Common Shares pursuant to this Plan. The Committee may provide for the elimination of fractions or for the settlement thereof in cash.

13. Withholding Taxes. To the extent that the Corporation is required to withhold federal, state, local or foreign taxes in connection with any payment made or benefit realized by a Participant or other person under this Plan, and the amounts available to the Corporation for such withholding are insufficient, it shall be a condition to the receipt of such payment or the realization of such benefit that the Participant or such other person make arrangements satisfactory to the Corporation for payment of the balance of such taxes required to be withheld. At the discretion of the Committee, such arrangements may include relinquishment of a portion of such benefit. In no event, however, shall the Corporation accept Common Shares for payment of taxes in excess of required tax withholding rates, except that, in the discretion of the Committee, a Participant or such other person may surrender Common Shares owned for more than six months to satisfy any tax obligations resulting from any such transaction.

14. Participation by Employees of a Less-Than-80-Percent Subsidiary. As a condition to the effectiveness of any grant or award to be made hereunder to a Participant who is an employee of a Less-Than-80-Percent Subsidiary, regardless whether such Participant is also employed by the Corporation or another Subsidiary, the Committee may require the Less-Than-80-Percent Subsidiary to agree to transfer to the Participant (as, if and when provided for under this Plan and any applicable agreement entered into between the Participant and the

Less-Than-80-Percent Subsidiary pursuant to this Plan) the Common Shares that would otherwise be delivered by the Corporation upon receipt by the Less-Than-80-Percent Subsidiary of any consideration then otherwise payable by the Participant to the Corporation. Any such award may be evidenced by an agreement between the Participant and the Less-Than-80-Percent Subsidiary, in lieu of the Corporation, on terms consistent with this Plan and approved by the Committee and the Less-Than-80-Percent Subsidiary. All Common Shares so delivered by or to a Less-Than-80-Percent Subsidiary will be treated as if they had been delivered by or to the Corporation for purposes of Section 3 of this Plan, and all references to the Corporation in this Plan shall be deemed to refer to the Less-Than-80-Percent Subsidiary except with respect to the definitions of the Board and the Committee and in other cases where the context otherwise requires.

15. Certain Terminations of Employment, Hardship and Other Special Circumstances. Notwithstanding any other provision of this Plan to the contrary, in the event of termination of employment by reason of death, disability, normal retirement, early retirement with the consent of the Corporation, termination of employment to enter public service with the consent of the Corporation or leave of absence approved by the Corporation, or in the event of hardship or other special circumstances, of a Participant who holds an Option Right or Appreciation Right that is or is not immediately and fully exercisable, any Restricted Shares as to which the substantial risk of forfeiture or the prohibition or restriction on transfer has not lapsed, any Deferred Shares as to which the Deferral Period is not complete, any Performance Shares or Performance Units that have not been fully earned, or any Common Shares that are subject to any transfer restriction pursuant to Section 10(b) of this Plan, the Committee may in its sole discretion take any action that it deems to be equitable under the circumstances or in the best interests of the Corporation, including, without limitation, accelerating the date when any such Option Right becomes exercisable, or waiving or modifying any other limitation or requirement with respect to any award under this Plan.

16. Foreign Employees. In order to facilitate the making of any grant or combination of grants under this Plan, the Committee may provide for such special terms for awards to Participants who are foreign nationals, or who are employed by the Corporation or any Subsidiary outside of the United States of America, as the Committee may consider necessary or appropriate to accommodate differences in local law, tax policy or custom. Moreover, the Committee may approve such supplements to, or amendments, restatements or alternative versions of, this Plan as it may consider necessary or appropriate for such purposes without thereby affecting the terms of this Plan as in effect for any other purpose, and the Secretary or other appropriate officer of the Corporation may certify any such document as having been approved and adopted in the same manner as this Plan. No such special terms, supplements, amendments or restatements shall include any provisions that are inconsistent with the terms of this Plan as then in effect unless this Plan could have been amended to eliminate such inconsistency without further approval by the shareholders of the Corporation.

17. Administration of the Plan. (a) This Plan shall be administered by the Compensation Committee of the Board, as constituted from time to time. The Committee shall be composed of not less than three members of the Board, each of whom shall be a nonemployee director within the meaning of Rule 16b-3 and an outside director within the meaning of Section 162(m) of the Code. A majority of the Committee shall constitute a quorum, and the acts of the members of the Committee who are present at any meeting thereof at which a quorum is present, or acts unanimously approved by the members of the Committee in writing, shall be the acts of the Committee.

(b) The interpretation and construction by the Committee of any provision of this Plan or of any agreement, notification or document evidencing the grant of Option Rights, Appreciation Rights, Restricted Shares or Deferred Shares, Performance Shares and Performance Units and any determination by the Committee pursuant to any provision of this Plan or any such agreement, notification or document, shall be final and conclusive. No member of the Committee shall be liable for any such action taken or determination made in good faith.

18. Amendments and Other Matters. (a) This Plan may be amended from time to time by the Committee; provided, however, that any amendment that must be approved by the shareholders of the Corporation in order to comply with applicable law or the rules of the New York Stock Exchange or, if the Common Shares are not traded on the New York Stock Exchange, the principal national securities exchange upon which the Common Shares are traded or quoted, shall not be effective unless and until such approval has been obtained. Presentation of this Plan or any amendment hereof for shareholder approval shall not be construed to limit the Corporation s authority to offer similar or dissimilar benefits under other plans or

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otherwise with or without shareholder approval. Without limiting the generality of the foregoing, the Committee may amend this Plan to eliminate provisions which are no longer necessary as a result of changes in tax or securities laws or regulations, or in the interpretation thereof.

(b) The Committee also may permit Participants to elect to defer the issuance of Common Shares or the settlement of awards in cash under the Plan pursuant to such rules, procedures or programs as it may establish for purposes of this Plan. In the case of an award of Restricted Shares, under Section 9, the deferral may be effected by the Participant s agreement to forego or exchange his or her award of Restricted Shares and receive an award of Deferred Shares. The Committee also may provide that deferred settlements include the payment or crediting of interest on the deferral amounts, or the payment or crediting of dividend equivalents where the deferral amounts are denominated in Common Shares.

(c) The Committee may condition the grant of any award or combination of awards under the Plan on the surrender or deferral by the Participant of his or her right to receive a cash bonus or other compensation otherwise payable by the Corporation or any Subsidiary to the Participant.

(d) This Plan shall not confer upon any Participant any right with respect to continuance of employment or other service with the Corporation or any Subsidiary and shall not interfere in any way with any right that the Corporation or any Subsidiary would otherwise have to terminate any Participant s employment or other service at any time.

(e) To the extent that any provision of this Plan would prevent any Option Right that was intended to qualify under particular provisions of the Code from so qualifying, such provision of this Plan shall be null and void with respect to such Option Right; provided, however, that such provision shall remain in effect with respect to other Option Rights, and there shall be no further effect on any provision of this Plan.

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EXHIBIT A

THE TIMKEN COMPANY

**Restricted Share Agreement for
Nonemployee Directors**

______________________, Grantee:

The Timken Company (the Company) pursuant to its Long-Term Incentive Plan (as Amended and Restated as of January 30, 2002) (the Plan) has this day granted to you, the above-named grantee, a total of ( ) Common Shares of the Company (Common Shares) subject to the following terms, conditions, limitations and restrictions:

1. The Common Shares subject to this grant shall be fully paid and nonassessable and shall be represented by a certificate or certificates registered in your name and endorsed with an appropriate legend referring to the restrictions hereinafter set forth. You shall have all the rights of a shareholder with respect to such shares, including the right to vote the shares and receive all dividends paid thereon, provided that such shares, and any additional shares that you may become entitled to receive by virtue of a share dividend, a merger or reorganization in which the Company is the surviving corporation or any other change in the capital structure of the Company, shall be subject to the restrictions hereinafter set forth.

2. The Common Shares subject to this grant may not be assigned, exchanged, pledged, sold, transferred or otherwise disposed of by you, except to the Company, and shall be subject to forfeiture as herein provided until five years have elapsed from the date of this grant, except that (a) 20 percent of such shares shall become freely transferable and nonforfeitable at the end of each year from and after the date of this grant and (b) your rights with respect to such shares may be transferred by will or pursuant to the laws of descent and distribution. Any purported transfer in violation of the provisions of this paragraph shall be null and void, and the purported transferee shall obtain no rights with respect to such shares.

3. All of the Common Shares subject to this grant that are then forfeitable shall be forfeited by you if your service as a member of the Board of Directors of the Company (a Director) is terminated before the fifth anniversary of the date of this grant; provided, however, if your service as a Director of the Company is terminated before the fifth anniversary of the date of this grant as a result of your death or disability, or owing to your removal as a Director without cause, a portion of the shares covered by this grant that then remain forfeitable shall become freely transferable and nonforfeitable as follows: that number of shares shall become freely transferable and nonforfeitable which bears the same ratio to the total number of shares subject to this grant that then remain forfeitable and would have become forfeitable at the next anniversary date as the number of full months from the date of this grant (or, if such service is terminated after the first anniversary of the date of this grant, then from the date of the latest anniversary) to the date of termination of such service bears to 12, and the balance of the shares subject to this grant shall be forfeited to the Company.

4. During the period in which the restrictions on transfer and risk of forfeiture provided in paragraphs 2 and 3 above are in effect, the certificates representing the Common Shares covered by this grant shall be retained by the Company, together with the accompanying stock power signed by you and endorsed in blank.

5. Upon any change in control of the Company, the restrictions on transfer and risk of forfeiture provided in paragraphs 2 and 3 above shall lapse and terminate with respect to all of the Common Shares that are subject to this grant to which such restriction and risk then remain applicable. For purposes of this grant, the term change in control shall mean the occurrence of any of the following events:

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(a) The acquisition by any individual, entity or group (within the meaning of Section 13(d)(3) or 14(d)(2) of the Exchange Act) (a Person) of beneficial ownership (within the meaning of Rule 13d-3 promulgated under the Exchange Act) of 30% or more of either: (i) the then-outstanding Common Shares or (ii) the combined voting power of the then-outstanding voting securities of the Company entitled to vote generally in the election of directors (Voting Shares); provided, however, that for purposes of this subsection (a), the following acquisitions shall not constitute a change in control: (A) any acquisition directly from the Company, (B) any acquisition by the Company, (C) any acquisition by any employee benefit plan (or related trust) sponsored or maintained by the Company or any Subsidiary, or (D) any acquisition by any Person pursuant to a transaction which complies with clauses (i), (ii) and (iii) of subsection (c) of this Section 5; or

(b) Individuals who, as of the date hereof, constitute the Board (the Incumbent Board) cease for any reason (other than death or disability) to constitute at least a majority of the Board; provided, however, that any individual becoming a director subsequent to the date hereof whose election, or nomination for election by the Company s shareholders, was approved by a vote of at least a majority of the directors then comprising the Incumbent Board (either by a specific vote or by approval of the proxy statement of the Company in which such person is named as a nominee for director, without objection to such nomination) shall be considered as though such individual were a member of the Incumbent Board, but excluding for this purpose, any such individual whose initial assumption of office occurs as a result of an actual or threatened election contest (within the meaning of Rule 14a-11 of the Exchange Act) with respect to the election or removal of directors or other actual or threatened solicitation of proxies or consents by or on behalf of a Person other than the Board; or

(c) Consummation of a reorganization, merger or consolidation or sale or other disposition of all or substantially all of the assets of the Company (a Business Combination), in each case, unless, following such Business Combination, (i) all or substantially all of the individuals and entities who were the beneficial owners, respectively, of the Common Shares and Voting Shares immediately prior to such Business Combination beneficially own, directly or indirectly, more than 66 2/3% of, respectively, the then-outstanding shares of common stock and the combined voting power of the then-outstanding voting securities entitled to vote generally in the election of directors, as the case may be, of the entity resulting from such Business Combination (including, without limitation, an entity which as a result of such transaction owns the Company or all or substantially all of the Company s assets either directly or through one or more subsidiaries) in substantially the same proportions relative to each other as their ownership, immediately prior to such Business Combination, of the Common Shares and Voting Shares of the Company, as the case may be, (ii) no Person (excluding any entity resulting from such Business Combination or any employee benefit plan (or related trust) sponsored or maintained by the Company or such entity resulting from such Business Combination) beneficially owns, directly or indirectly, 30% or more of, respectively, the then-outstanding shares of common stock of the entity resulting from such Business Combination, or the combined voting power of the then-outstanding voting securities of such corporation except to the extent that such ownership existed prior to the Business Combination, and (iii) at least a majority of the members of the board of directors of the corporation resulting from such Business Combination were members of the Incumbent Board at the time of the execution of the initial agreement, or of the action of the Board, providing for such Business Combination; or

(d) Approval by the shareholders of the Company of a complete liquidation or dissolution of the Company.

6. This grant of restricted Common Shares is made pursuant to the Plan, a copy of which is attached hereto. This grant is subject to all of the terms and provisions of the Plan, which are incorporated herein by reference. Capitalized terms used herein without definition shall have the meanings assigned to them in the Plan.

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Dated this _______ day of ___________________, 200___

THE TIMKEN COMPANY

By: ____

Name:
Title:

Accepted and agreed to: ____________________
Dated: ____________________

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EXHIBIT B

THE TIMKEN COMPANY

Nonqualified Stock Option Agreement for Nonemployee Directors

WHEREAS, (the Optionee) is a nonemployee Director (a Nonemployee Director) of The Timken Company (the Company).

NOW, THEREFORE, pursuant to the Company s Long-Term Incentive Plan (as Amended and Restated as of January 30, 2002) (the Plan) and subject to the terms and conditions thereof and the terms and conditions hereinafter set forth, the Company hereby grants to (the Optionee), effective as of the date of the Annual Meeting of Shareholders of the Company last written below (the Date of Grant) a nonqualified stock option (the Option) to purchase 3,000 shares of the Company s common stock without par value (the Common Shares) at the exercise price of ($) per Common Share (the Exercise Price).

1. Vesting of Option**.** (a) Unless terminated as hereinafter provided, the Option shall be exercisable with respect to all of the Common Shares covered by the Option after the Optionee continuously serves as a Nonemployee Director of the Company for a period of one (1) year following the Date of Grant.

(b) Notwithstanding the provisions of Section 1(a) hereof, the Option shall become immediately exercisable in full upon any change in control of the Company that shall occur while the Optionee is a Nonemployee Director of the Company. For the purposes of this agreement, the term change in control shall mean the occurrence of any of the following events:

(i) The acquisition by any individual, entity or group (within the meaning of Section 13(d)(3) or 14(d)(2) of the Exchange Act) (a Person) of beneficial ownership (within the meaning of Rule 13d-3 promulgated under the Exchange Act) of 30% or more of either: (A) the then-outstanding Common Shares or (B) the combined voting power of the then-outstanding voting securities of the Company entitled to vote generally in the election of directors (Voting Shares); provided, however, that for purposes of this subsection (i), the following acquisitions shall not constitute a change in control: (1) any acquisition directly from the Company, (2) any acquisition by the Company, (3) any acquisition by any employee benefit plan (or related trust) sponsored or maintained by the Company or any Subsidiary, or (4) any acquisition by any Person pursuant to a transaction which complies with clauses (A), (B) and (C) of subsection (iii) of this Section 1(b); or

(ii) Individuals who, as of the date hereof, constitute the Board (the Incumbent Board) cease for any reason (other than death or disability) to constitute at least a majority of the Board; provided, however, that any individual becoming a director subsequent to the date hereof whose election, or nomination for election by the Company s shareholders, was approved by a vote of at least a majority of the directors then comprising the Incumbent Board (either by a specific vote or by approval of the proxy statement of the Company in which such person is named as a nominee for director, without objection to such nomination) shall be considered as though such individual were a member of the Incumbent Board, but excluding for this purpose, any such individual whose initial assumption of office occurs as a result of an actual or threatened election contest (within the meaning of Rule 14a-11 of the Exchange Act) with respect to the election or removal of directors or other actual or threatened solicitation of proxies or consents by or on behalf of a Person other than the Board; or

(iii) Consummation of a reorganization, merger or consolidation or sale or other disposition of all or substantially all of the assets of the Company (a Business Combination), in each case, unless, following such Business Combination, (A) all or substantially all of the individuals and entities who were the beneficial owners, respectively, of the Common Shares and Voting Shares immediately prior to such Business Combination beneficially own, directly or indirectly, more than 66-2/3% of, respectively, the then-outstanding shares of common stock and the combined voting power of the then-outstanding voting securities entitled to vote generally in the election of directors, as the case may be, of the entity resulting from such Business Combination (including, without limitation, an entity which as a result of such transaction owns the Company or all or substantially all of the Company s assets either directly or through one or more subsidiaries) in substantially the same proportions relative to each other as their ownership, immediately prior to such Business Combination, of the Common Shares and Voting Shares of the Company, as the case may be, (B) no Person (excluding any entity resulting from such Business Combination or any employee benefit plan (or related trust) sponsored or maintained by the Company or such entity resulting from such Business Combination) beneficially owns, directly or indirectly, 30% or more of, respectively, the then-outstanding shares of common stock of the entity resulting from such Business Combination, or the combined voting power of the then-outstanding voting securities of such corporation except to the extent that such ownership existed prior to the Business Combination, and (C) at least a majority of the members of the board of directors of the corporation resulting from such Business Combination were members of the Incumbent Board at the time of the execution of the initial agreement, or of the action of the Board, providing for such Business Combination; or

(iv) Approval by the shareholders of the Company of a complete liquidation or dissolution of the Company.

(c) Notwithstanding the provisions of Section 1(a) hereof, the Option shall become immediately exercisable in full if the Optionee should (i) retire (within the meaning in the Board s General Policies & Procedures), (ii) die, (iii) become permanently disabled (within the meaning of the Company s long-term disability plan) while serving as a Nonemployee Director of the Company, or (iv) otherwise cease to be a Nonemployee Director of the Company for any reason; provided, however, that this Option shall become immediately exercisable in full pursuant to Section 1(c)(iv) only if the Optionee shall have continuously served as a Nonemployee Director for at least six months following the Date of Grant.

(d) To the extent that the Option shall have become exercisable in accordance with the terms of this agreement, it may be exercised in whole or in part from time to time thereafter.

2. Termination of Option. The Option shall terminate automatically and without further notice on the earliest of the following dates:

(a) five years after the date upon which the Optionee ceases to be a Nonemployee Director of the Company or subsidiary for any reason, except death;

(b) one year after the date of the Optionee s death; or

(c) ten years after the Date of Grant.

3. Payment of Exercise Price. The Exercise Price shall be payable (a) in cash in the form of currency or check or other cash equivalent acceptable to the Company, (b) by transfer to the Company of nonforfeitable, unrestricted Common Shares that have been owned by the Optionee for at least six months prior to the date of exercise or (c) by any combination of the methods of payment described in Sections 3(a) and 3(b) hereof. Nonforfeitable, unrestricted Common Shares that are transferred by the Optionee in payment of all or any part of the Exercise Price shall be valued on the basis of their fair market value as determined by the Committee from time to time. Subject to the terms and conditions of Section 4 hereof, and subject to any deferral election the Optionee may have made pursuant to any plan or program of the Company, the Company shall cause certificates for any shares purchased hereunder to be delivered to the Optionee upon payment of the Exercise Price in full.

4. Compliance with Law. The Company shall make reasonable efforts to comply with all applicable federal and state securities laws; provided, however, notwithstanding any other provision of this agreement, the Option shall not be

exercisable if the exercise thereof would result in a violation of any such law. To the extent that the Ohio Securities Act shall be applicable to the Option, the Option shall not be exercisable unless the Common Shares or other securities covered by the Option are (a) exempt from registration thereunder, (b) the subject of a transaction that is exempt from compliance therewith, (c) registered by description or qualification thereunder or (d) the subject of a transaction that shall have been registered by description thereunder.

5. Transferability and Exercisability.

(a) Except as provided in Section 5(b) below, the Option including any interest in thereof, shall not be transferable by the Optionee except by will or the laws of descent and distribution, and the Option shall be exercisable during the lifetime of the Optionee only by him or, in the event of his legal incapacity to do so, by his guardian or legal representative acting on behalf of the Optionee in a fiduciary capacity under state law and court supervision.

(b) Notwithstanding Section 5(a) above, the Option or any interest in thereof, may be transferable by the Optionee, without payment of consideration therefor, to any one or more members of the immediate family of Optionee (as defined in Rule 16a-1(e) under the Exchange Act), or to one or more trusts established solely for the benefit of such members of the immediate family or to partnerships in which the only partners are such members of the immediate family of the Optionee; provided, however, that such transfer will not be effective until notice of such transfer is delivered to the Company; and provided, further, however, that any such transferee is subject to the same terms and conditions hereunder as the Optionee.

6. Adjustments. The Committee shall make any adjustments in the Exercise Price and the number or kind of shares of stock or other securities covered by the Option that the Committee may determine to be equitably required to prevent any dilution or expansion of the Optionee s rights under this agreement that otherwise would result from any (a) stock dividend, stock split, combination of shares, recapitalization or other change in the capital structure of the Company, (b) merger, consolidation, separation, reorganization or partial or complete liquidation involving the Company or (c) other transaction or event having an effect similar to any of those referred to in Section 6(a) or 6(b) hereof. Furthermore, in the event that any transaction or event described or referred to in the immediately preceding sentence shall occur, the Committee may provide in substitution of any or all of the Optionee s rights under this agreement such alternative consideration as the Committee may determine in good faith to be equitable under the circumstances.

7. Amendments. Any amendment to the Plan shall be deemed to be an amendment to this agreement to the extent that the amendment is applicable hereto; provided, however, that no amendment shall adversely affect the rights of the Optionee with respect to the Option without the Optionee s consent.

8. Severability. In the event that one or more of the provisions of this agreement shall be invalidated for any reason by a court of competent jurisdiction, any provision so invalidated shall be deemed to be separable from the other provisions hereof, and the remaining provisions hereof shall continue to be valid and fully enforceable.

9. Governing Law. This agreement is made under, and shall be construed in accordance with, the laws of the State of Ohio.

10. Relation to Plan. Capitalized terms used herein without definition shall have the meanings assigned to them in the Plan.

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Dated this _______ day of ___________________, 200___

THE TIMKEN COMPANY

By: ____

Name:
Title:

Accepted and agreed to: ____________________
Dated: ____________________

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THE TIMKEN COMPANY
Proxy Solicited on Behalf of the Board of Directors

P R O X Y

The undersigned appoints W.R. Timken, Jr., James W. Griffith, Bill J. Bowling, and Scott A. Scherff, and each of them, as true and lawful proxies, with full power of substitution, to vote and act for the undersigned as specified on the reverse hereof at the Annual Meeting of Shareholders of THE TIMKEN COMPANY to be held at 1835 Dueber Avenue, S.W., Canton, Ohio, on April 16, 2002, at 10:00 A.M., and at any adjournment thereof, as fully as the undersigned could vote and act if personally present on the matters set forth on the reverse hereof, and, in their discretion on such other matters as may properly come before the meeting, and/or if the undersigned is a participant in one or more of the Company s or its subsidiaries associate share ownership plans and has stock of the Company allocated to his or her account(s), the undersigned directs the trustee(s) of such plan(s) likewise to appoint the above-named individuals as proxies to vote and act with respect to all shares of such stock so allocated on the record date for such meeting in the manner specified on the reverse hereof at such meeting or any adjournment thereof, and in their discretion on such other matters as may properly come before the meeting.

ITEM 1. ELECTION OF DIRECTORS
Elect Robert W. Mahoney (01), Jay A. Precourt (02), Ward J. Timken, Jr. (03), and Joseph F. Toot, Jr. (04) in Class II for a term expiring at the 2005 Annual Meeting.

ITEM 2. APPROVAL OF THE TIMKEN COMPANY LONG-TERM INCENTIVE PLAN, AS AMENDED AND RESTATED AS OF JANUARY 30, 2002.

SEE REVERSE SIDE TO VOTE BY MAIL

- FOLD AND DETACH HERE -

NOW YOU CAN VOTE YOUR SHARES BY TELEPHONE OR INTERNET.
IT S CONVENIENT AND COST-EFFECTIVE.

1. To vote by telephone: Using a touch-tone telephone, call 1-877-PRX-VOTE (1-877-779-8683) from the U.S. or dial 201-536-8073 from other countries. You will be asked to enter the **Voter Control Number** located in the box just below the perforation on the proxy card. Then follow the instructions.

2. To vote by internet: Point your browser to the web address: *http://www.eproxyvote.com/tkr*. Click on the PROCEED icon You will then be asked to enter the **Voter Control Number** located in the box just below the perforation on the proxy card. Then follow the instructions.

Of course, if you prefer to vote your shares by completing your proxy card and returning it in the envelope provided, you are still welcome to do so.

Annual Meeting Of Shareholders

April 16, 2002
10:00 a.m.
Corporate Auditorium (CIG)

Parking: Shareholders attending the meeting may park in the visitor lot behind the Corporate Office building.

Note: If your shares are held in street name, please bring a letter with you from your broker stating as such to the

The Timken Company
1835 Dueber Avenue, S.W.
Canton, OH 44706-2798
Telephone: (330) 438-3000
For directions to the Annual Meeting
you may call 330-471-3378.

Annual Meeting.

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[X] **Please mark your votes as in this example.**

The shares represented by this proxy will be voted as recommended by the Board of Directors unless otherwise specified.

The Board of Directors recommends a vote FOR these Items.

	FOR	**WITHHELD**	**ITEM 1. ELECTION OF DIRECTORS TO SERVE IN CLASS II FOR A TERM OF THREE YEARS**	
1. Election of Directors. (see reverse)	[ ]	[ ]	01. Robert W. Mahoney 02. Jay A. Precourt in Class II for a term expiring at the 2005 Annual Meeting.	03. Ward J. Timken, Jr. 04. Joseph F. Toot, Jr.

For, except vote withheld from the following nominee(s):

		FOR	AGAINST	ABSTAIN
2.	Approval of The Timken Company Long-Term Incentive Plan, as amended and restated January 30, 2002.	[ ]	[ ]	[ ]

NOTE: Please sign exactly as name appears hereon. Joint owners should each sign. When signing as an attorney, executor, administrator, trust or guardian, please give full title as such.

FOLD TO DETACH HERE OR SEE REVERSE
FOR INSTRUCTIONS TO VOTE YOUR SHARES BY TELEPHONE OR INTERNET

THE TIMKEN COMPANY
Canton, Ohio

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS

The Annual Meeting of Shareholders of The Timken Company will be held on Tuesday, April 16, 2002, at 10:00 A.M., at 1835 Dueber Avenue, S.W., Canton, Ohio, for the following purposes:

1. To elect four Directors to serve in Class II for a term of three years.

2. To approve The Timken Company Long-Term Incentive Plan, as amended and restated as of January 30, 2002.

3. To transact such other business as may properly come before the meeting.

Holders of Common Stock of record at the close of business on February 15, 2002, are the shareholders entitled to notice of and to vote at the meeting.

YOUR VOTE IS IMPORTANT AND, WHETHER OR NOT YOU PLAN TO ATTEND THE ANNUAL MEETING, PLEASE SIGN AND DATE THE PROXY CARD ABOVE AND RETURN IT IN THE POSTAGE-PREPAID ENVELOPE PROVIDED OR VOTE YOUR SHARES ELECTRONICALLY THROUGH THE INTERNET OR BY TELEPHONE. INSTRUCTIONS FOR VOTING ELECTRONICALLY ARE PROVIDED ON THE REVERSE OF THIS CARD.

SCOTT A. SCHERFF
Corporate Secretary and
Assistant General Counsel

February 20, 2002

YOUR VOTE IS IMPORTANT. PLEASE RETURN YOUR PROXY CARD OR VOTE ELECTRONICALLY.