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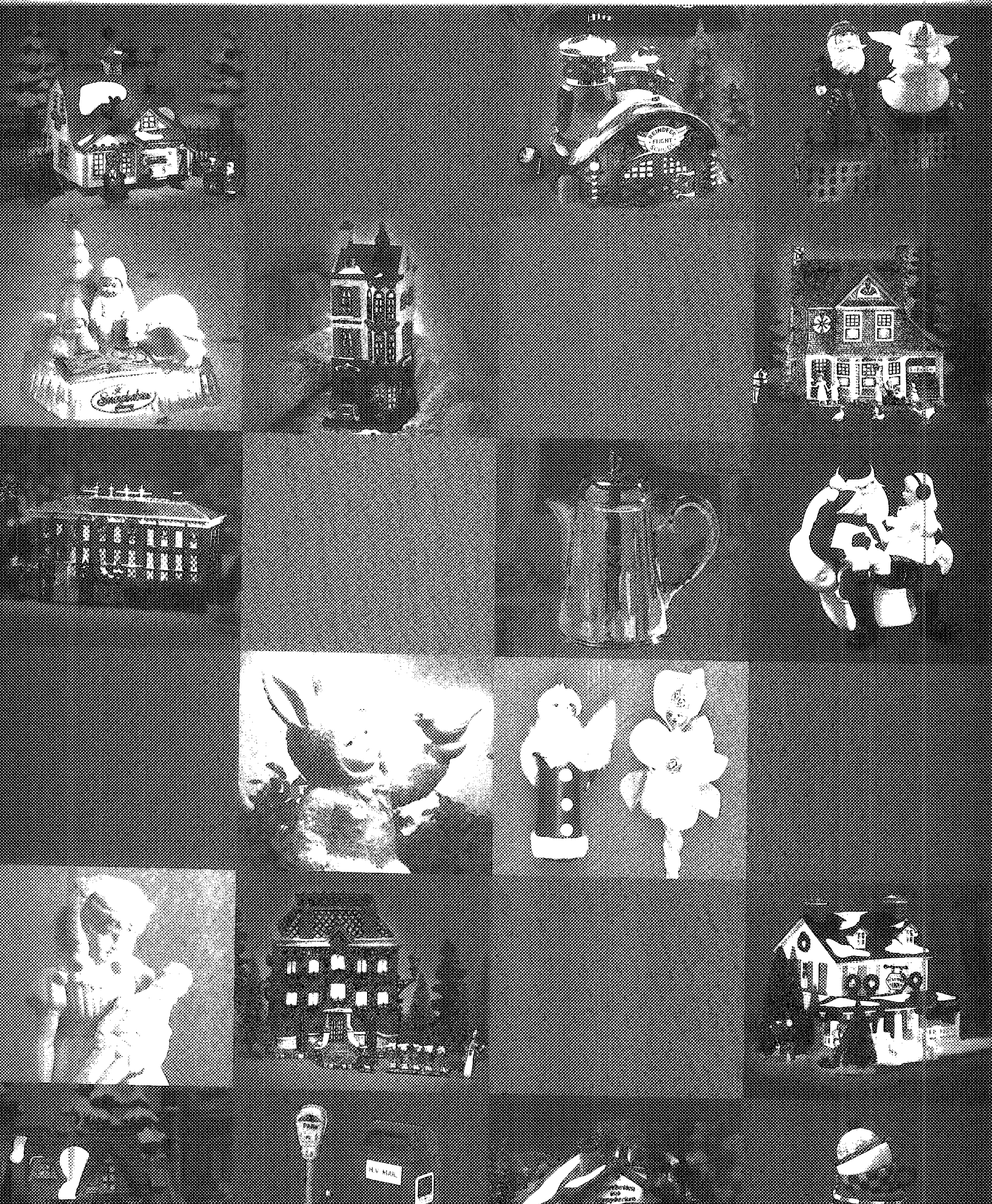
Department 56

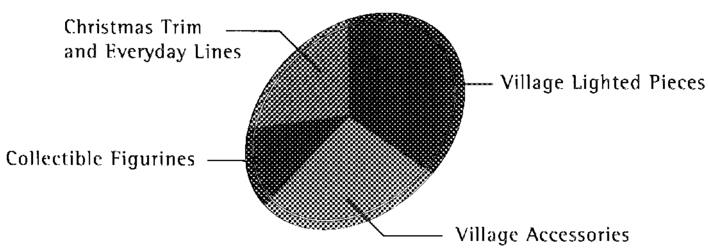

REINDEER FLIGHT SCHOOL
H.V. MAIL

You are "in creative company" with Department 56, for we are truly powered by creativity.

Department 56, Inc. is a leading collectibles and giftware company known for its lighted Villages, Snowbabies™ figurines and extensive lines of holiday and home decorative products. We sell our products primarily through gift, specialty and department store retailers in the United States, Canada and Europe. Department 56 seeks to expand its market presence through creative product development and marketing, as well as through acquisitions.

Department 56 currently offers more than 3,000 products of which more than a third are new in 1999. Our annual product introductions and retirements create continuity and vitality among our core product lines.

1998 SALES DISTRIBUTION



FINANCIAL HIGHLIGHTS

(Dollars in thousands, except per share amounts)	1998	1997	1996
Net Sales	$243,365	$219,496	$228,775
Income from Operations	81,009	71,107	81,155
Net Income*	46,516	41,037	45,944
Net Income per Share*	2.45	1.96	2.11
Working Capital	$ 29,276	$ 40,857	$ 67,997
Total Assets	233,283	259,695	285,733
Long-Term Debt	20,000	40,000	60,000
Stockholders' Equity	178,735	186,655	196,757

**1997 net income and net income per share assuming dilution exclude the gain on sale of aircraft, net of income taxes.*

SHAREHOLDERS' LETTER

1998 was a very good year for Department 56 and its shareholders, consumers, employees and dealers, as we reported record earnings per share and renewed sales growth by continuing to excite existing and new consumers alike with innovative products. We also offered fresh ways for our dealers to reach out to new consumers, substantially improved our capacity to grow and launched an important Village line called Seasons Bay.™ We generated $89 million in operating cash flow and continued our share repurchase program, buying back almost 1.7 million shares.

As this report highlights, our success comes from both the innovation generated by collaboration among our creative, marketing and sales staffs and our ability to execute because of our strong infrastructure.

Sales growth in 1998 resulted from exciting new introductions across our product lines and creative marketing programs to support them. Increased interior detail within our products continued to captivate our consumers, while our old-fashioned McDonald's® restaurant and Hershey's® candy store appealed to both existing and new consumers. Our limited-edition Kensington Palace attracted those wishing to honor the memory of Princess Diana, and Dorothy and Toto made a surprise visit as guests of the Snowbabies. Our entries into Halloween and the fall and Thanksgiving holiday period, with the introduction of our Harvest™ tabletop line, were very well received. Our Christmas trim lines continued to expand, and one theme, Once Upon A Starry Night,™ was our largest ever. An exciting year was capped off by the strong performance of our Village gift sets introduced during our annual fall marketing event.

1998 also saw an expansion in the capacity of our infrastructure to support growth. We fortified our marketing resources by adding key talent in brand management and database/direct marketing. We implemented new Year 2000-compliant, enterprise-wide integrated software that serves all aspects of our business from order taking through distribution to our dealers, and significantly improves our ability to support ongoing growth, whether internal or through acquisitions. We assumed direct control of our showrooms in New York and Los Angeles, and established a direct sales force in Canada. We also established an in-house sculpting studio that expands capacity and allows closer collaboration with our artists.

Looking forward to 1999, we are continuing to pursue three avenues of growth – growing our existing product lines, launching new product lines and seeking attractive complementary acquisitions.

During this past year we successfully launched a number of line extensions. For example, as part of the Snowbabies line we premiered the Snowbabies Guest Collection™ that will feature characters such as Dorothy from *The Wizard of Oz* and Madeline™ visiting Snowbabies' Frosty Frolic Land.™ This line appeals to current consumers as well as opens a door to collectors of other brands.

In addition to several new innovations in our existing product line for 1999, we are pleased with the launch of our first new Village series in five years. Seasons Bay represents the first village with a "year-round" theme and brings together the best of our product innovation and design. This new collection allows consumers to enjoy changing their displays throughout the year. Dealers are responding positively to this new line. In addition, we plan to announce another innovative product line in May.

We continue to believe that acquisitions will also play an integral role in our growth strategy. The collectible industry continues to grow at attractive rates, due in large measure to the expanding appeal of products designed and marketed by smaller companies founded by highly creative and focused management teams. We believe several of these teams will recognize that we can jointly benefit by combining forces.

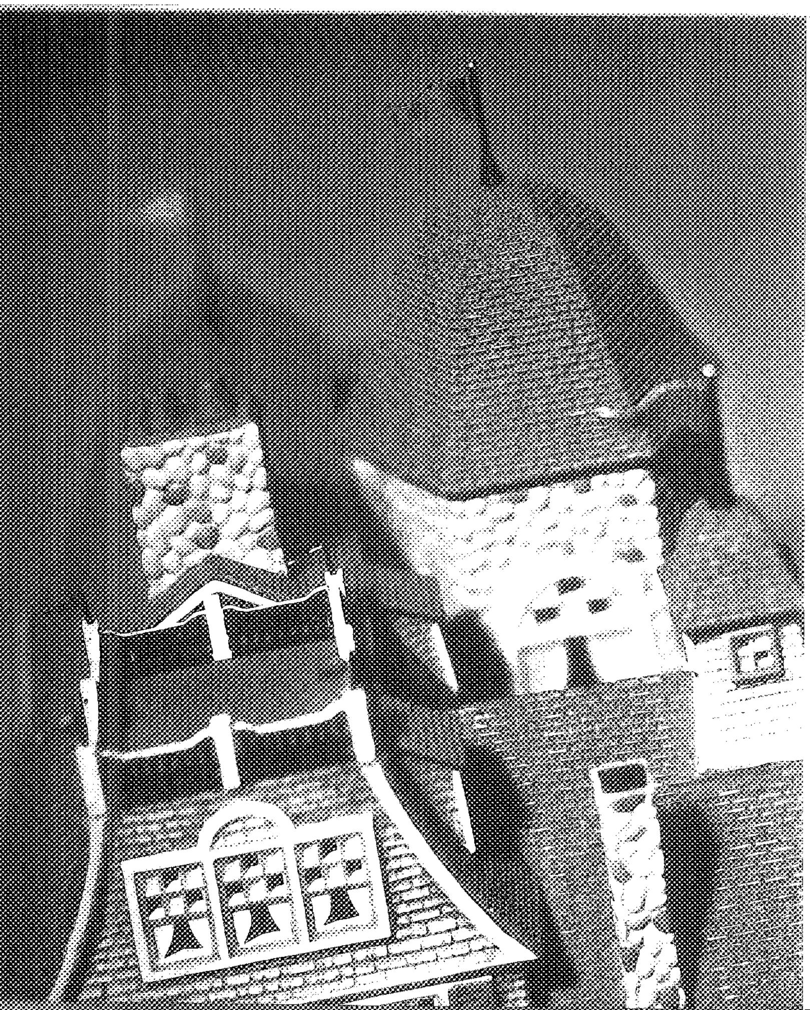
We look to continue to invest in Department 56's future in 1999. We are working to improve our distribution systems by consolidating three smaller centers into one large facility. The new center will increase efficiency and capacity to facilitate our growth. We are also very excited about the May 1999 opening of our first retail store in the Mall of America in Minneapolis that will enable us to build brand awareness, thereby benefiting our traditional retail outlets.

Our Board continues to provide strong support to the company's management. We want to thank Sandra Horbach and Todd Bachman, who left the Board this past year, for their many contributions since Department 56 went public in 1993. In addition, we want to thank our long-time Board directors, Brian Little, Steve Rothmeier and Vin Weber, as well as our new directors, Maxine Clark, Gary Matthews and Jay Chiat, for their enthusiasm for and involvement with the company.

I would also like to thank our dealers for their tireless dedication to Department 56 and would like to especially thank all our employees and sales reps (pictured throughout this report) for their loyalty, creativity and hard work.

These are exciting times for Department 56 as we enter the new millennium. The company is a major force in collectibles and giftware and we are actively exploring new avenues for growth. We expect 1999 to be another excellent year for Department 56. Current orders are meeting expectations and consumer interest is strong. Our existing lines are performing well, enhanced by product line extensions and new line introductions. We will continue investing in new ways to market, as well as in enhanced distribution and data management. Leveraging our exceptional consumer franchise, we remain confident that we will achieve our growth goals as we continue to expand our leadership in collectibles and giftware.

Chairwoman and Chief Executive Officer



PRODUCTS OF IMAGINATION

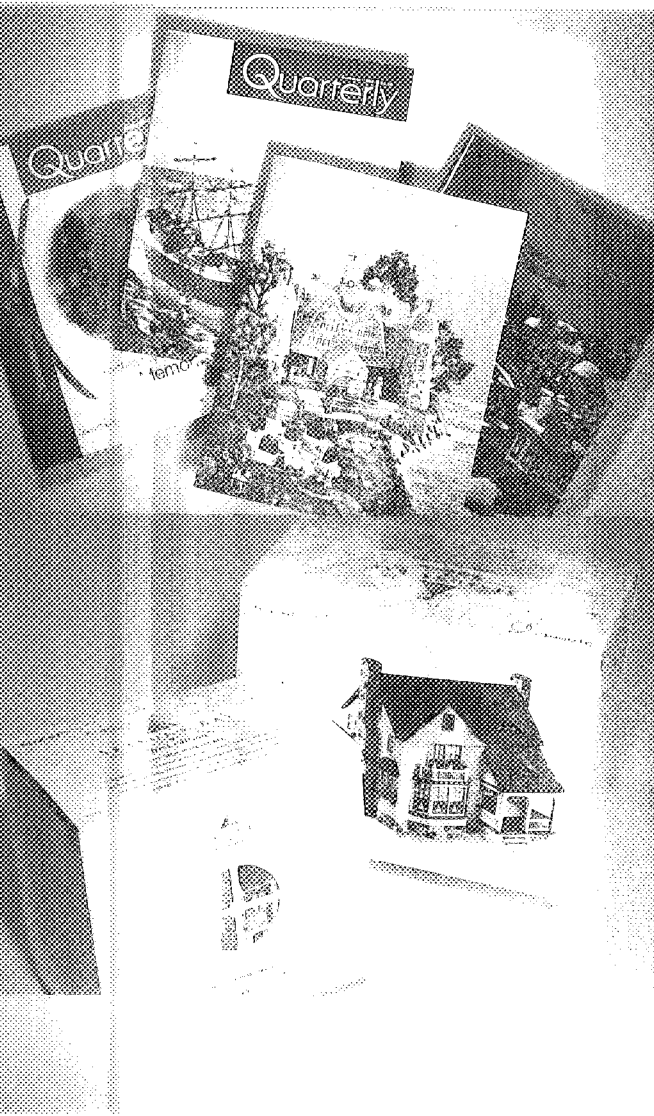
At Department 56, creative product innovation is a cornerstone of our success and a foundation for our future growth. The challenge is not only to deliver against the market's expectations, but to do so in a way that maintains an element of anticipation. We want our customers – dealers and collectors alike – to anticipate our latest designs and always wonder: What's next?

We recognize that what draws our customers to our products is their look, clever design and intricate detail. For example, putting motion within our products has added a new dimension to enjoyment. In 1998, consumers were especially taken with both our Carnival Carousel, inside of which they can see horses circling about while listening to carnival music, and by the Haunted Mansion, where ghosts and goblins are flying throughout the house scaring Halloween trick-or-treaters. Our company-wide commitment is to create intriguing products and push the envelope on product detail and design, as we strive to offer our customers the "unexpected" and the latest in technical design.

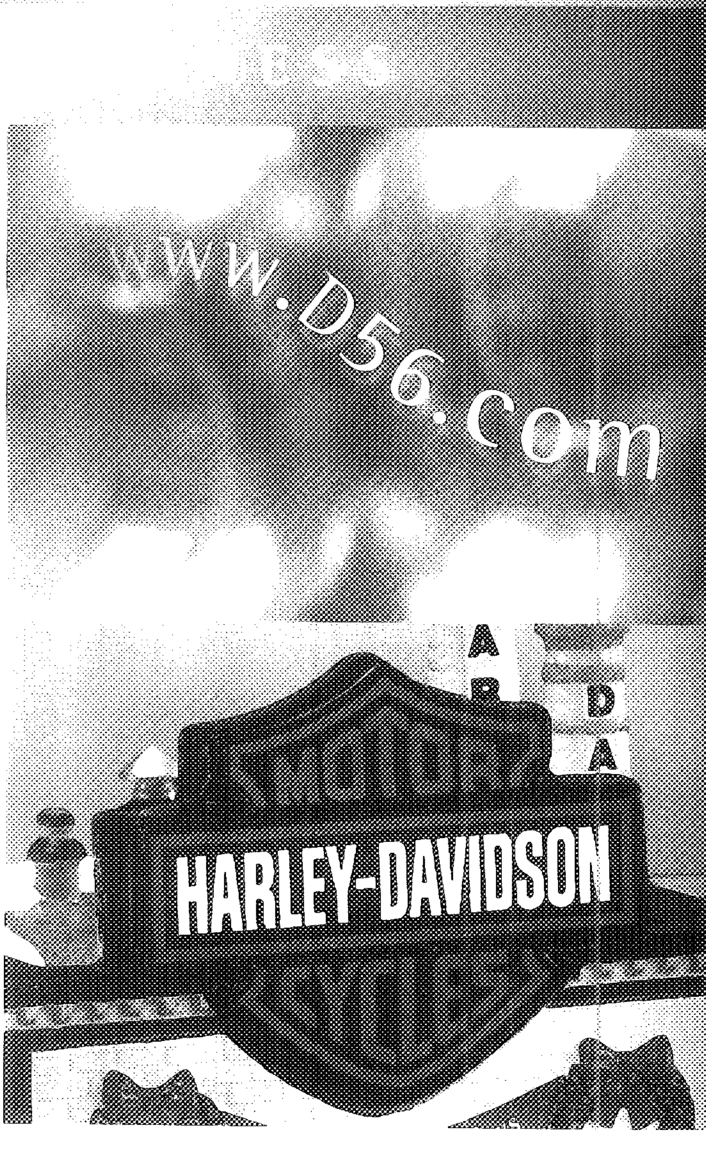
This year, these efforts culminated in our first new Village series in several years, Seasons Bay. Our first year-round village, it represents a resort town anywhere in late 19th-century America. The centerpiece, the Grandview Shores Hotel, is an excellent example of the technological expertise and level of artistry incorporated into our products, with each piece requiring 620 hand cuts to create the windows alone. We have designed painted pewter accessories that are in scale with the buildings and specific to winter, spring, summer and fall in order to allow for display all year long. The initial response from our dealers has been encouraging.

We are also expanding established lines by introducing new series within existing series. Two of these new series feature stand-alone items, perfect for gifts or collecting. The Literary Classics™ line is based on characters from some of the world's most famous novels, beginning with Charles Dickens' *Great Expectations*. In the spring, we expect to introduce our next piece in this line, based on the American classic *Little Women*. Each package includes not only a beautifully lit classic house and accessory pieces, but an heirloom bound copy of the novel as well. Similarly, the Historical Landmark Series™ has been extended to include Great Britain's Big Ben, as well as our first American Landmark, Independence Hall with its Liberty Bell, to celebrate America's millennium contribution to the world of a working democracy. In addition, we are launching an extension of our North Pole Series™ called Elf Land,™ a suburb where elves live and play after the Christmas chores are finished, which should delight adults and children alike.

Looking ahead, Department 56 will continue investing in originality and design to strengthen our bond with current collectors and to bring new customers into our franchise. Our artisans, renowned for their creativity and inventiveness, will keep offering new ideas, which in turn will be manufactured with exacting detail. In short, we are ready to continue building on our reputation for innovation and imagination.


Quarterly


HOMES
for the
HOLIDAYS


WWW.D56.com
HARLEY-DAVIDSON

We strongly believe that it is a partnership forged among product development, marketing and sales that will accelerate Department 56's growth. Our accomplishments in 1998 are the foundation for intensifying efforts in 1999.

Among our most important accomplishments is the depth we have added by hiring seasoned individuals with proven experience in brand management, database/direct marketing and product development. These additions complement nicely the creative, marketing communications and industry experience we have in place. These resources allow us to focus on developing and executing innovative, profitable marketing programs that build our business.

In 1998, we began a concerted effort to build our brand equity. Our first steps included making the Department 56 brand name more prominent on our product, as well as in our marketing communications. We introduced new four-color packaging for all new Village products that highlights the Department 56 name, a noticeable upgrade from the black and white packaging of the past. In addition, we selectively used national print advertising in such magazines as *People* and *Martha Stewart Living* to promote awareness of our Village gift sets and limited-edition Kensington Palace.

By linking our brand name with other well-established brand names, we not only generate strong sales, but also attract new consumers to the franchise. Examples in 1999 include the Ford® dealership and Harley® manufacturing plant, as well as the coupling of *The Wizard of Oz* characters with Snowbabies.

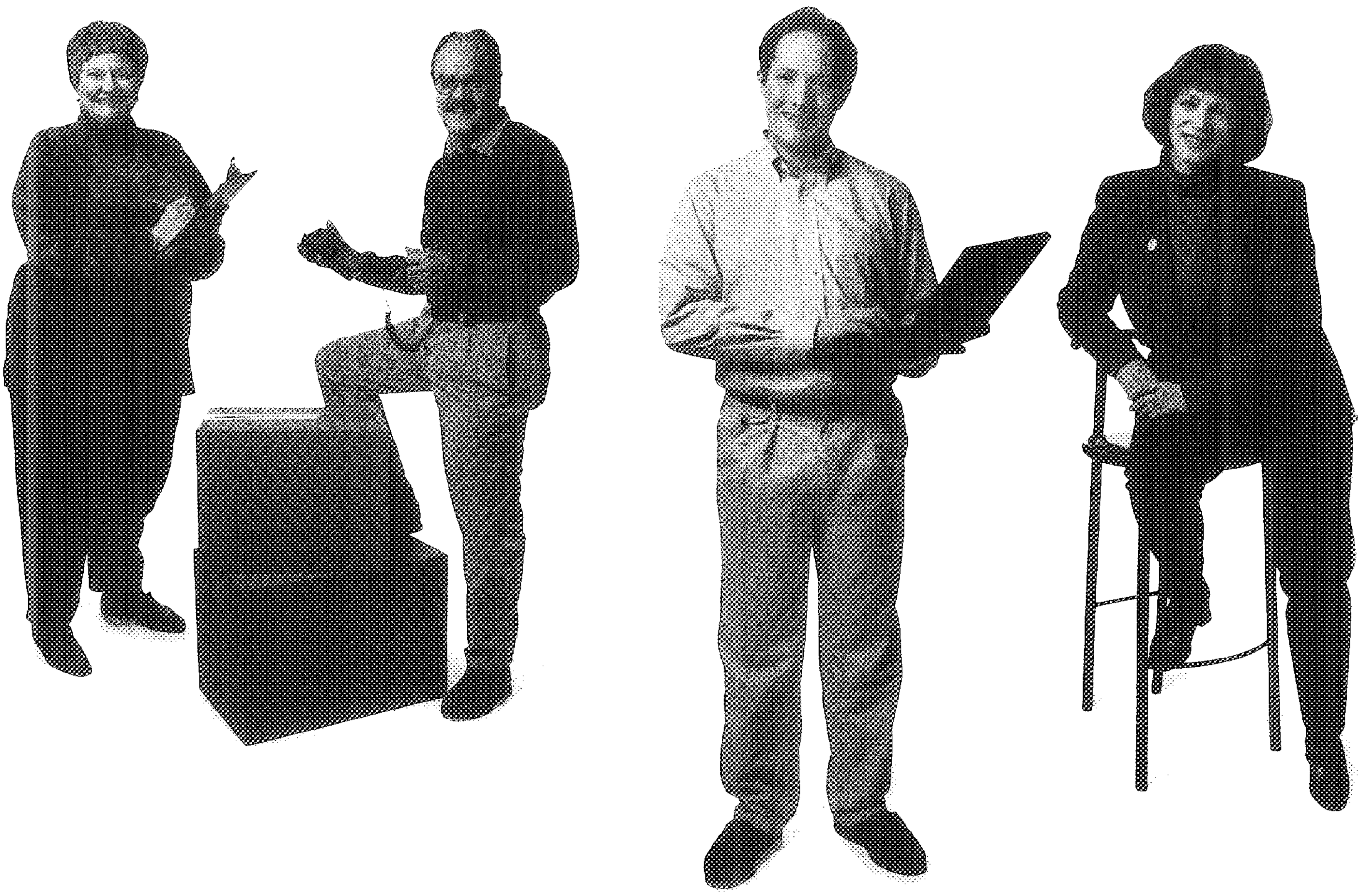
Impactful events at retail also help to build brand awareness. Our 1998 Homes for the Holidays event was our most successful holiday event to date. In 1999, we are introducing our first summer event with new and unique products to provide dealers with the opportunity to create interest and excitement prior to the start of the holiday season.

Merchandising, display and well-informed, enthusiastic sales associates at the point of sale are critical elements of our success. We continue to build on the strong communications embodied in our new packaging and event marketing collateral, our consumer *Quarterly* magazine, sales associate training materials and our dealer newsletter, *On Time*, which offers a stream of merchandising ideas to dealers six to eight times a year.

We are gaining additional brand exposure by exploring avenues for reaching new consumers that complement and strengthen our existing channels. In 1998, we consolidated all of our consumer lists and began developing programs to build and strengthen consumer loyalty. We are also exploring opportunities that allow us to tap into groups of people we would not otherwise reach through our regular channels. Additionally, we continue to selectively market products on QVC, the nationally recognized home shopping channel, gaining additional brand exposure to attract new consumers.

Perhaps one of our most exciting ventures is the planned opening in May of our first retail store in the Mall of America. This 8,000-square-foot store, located in one of the nation's most popular tourist attractions, will enhance our brand and product profile. We are seeking to entice new consumers into our franchise and then return them to their local dealers for future purchases. Our retail store will also allow us to expose current, as well as new, consumers to the full breadth of product that we offer.

Combined, all of these efforts promise to heighten the awareness of the Department 56 brand and lead us into another exciting year in 1999.



DESIGNED FOR GROWTH

As we look to develop new avenues of growth and to expand our current ones, Department 56 is actively investing in the company's infrastructure to ensure capabilities and systems are in place to maintain the company's competitive edge. This capacity to grow is critical to position us to accelerate our organic growth, as well as to quickly and seamlessly integrate acquired companies into Department 56's core operations.

Having efficient operational capabilities in place is especially important for companies looking to join Department 56. Often these are smaller, newer organizations that have successfully launched brilliantly designed collectibles and giftware, but which soon are consumed by the challenges inherent in meeting growing operational demands. What was initially a passionate and exciting venture evolves into a complex, often overwhelming and costly exercise. These companies remain committed to maintaining the unique edge that distinguishes them in the market, but they want to find a partner to help facilitate their future growth without damaging their heritage.

Our investments over the last two years in production, distribution and enterprise systems make us well poised to be that partner, as well as to meet our own needs. For example, in China, where Department 56 is one of the largest contract manufacturers of porcelain and ceramic products, we continue to expand our network of production sources and improve upon our ability to achieve the quality control and on-time production critical to our markets.

Recognizing that creativity is the bedrock of our heritage, we also continue to invest in our design and sculpting capability, which for many years has distinguished Department 56 in the market. Our meticulous pieces are fashioned to meet exacting standards and, in 1998, to further augment our design capacity, we added not only additional artists, but also an in-house sculpting studio. The new studio will not only increase our creative capacity, but also provide more timely and fluid communication between artists and sculptors.

Experience has shown that having a dedicated sales force focused on our marketing priorities is a significant asset and an attraction for prospective acquisitions. We are pleased that during the last year, we have been able to bring our showrooms in New York, Los Angeles and Canada directly into the Department 56 family.

An efficient distribution system is also essential to serve our broad-based and decentralized retail network. We recently announced the consolidation of three Minneapolis-based distribution centers into one centralized facility. Designed for significant future growth at 337,500 square feet, the facility not only ensures cost savings, but also cost-effective and rapid distribution of our products throughout North America.

Last, but certainly not least, state-of-the-art systems software is virtually mandatory for any large corporation to effectively manage global enterprises in the 21st century. After two years of hard work, we have implemented integrated, enterprise-wide, Year 2000-compliant software throughout our company. Just one example of how we are benefiting from this software is the ability to easily process orders for multiple companies in multiple currencies.

Taken together, all of these steps position our company to effectively accelerate internal product development, launch new products, penetrate new markets, leverage acquisitions, and establish a foundation for continued revenue and profit growth.

FIVE-YEAR SUMMARY

(In thousands, except per share amounts)	Year Ended Jan. 2, 1999 [1]	Year Ended Jan. 3, 1998 [1]	Year Ended Dec. 28, 1996 [1]	Year Ended Dec. 30, 1995 [1]	Year Ended Dec. 31, 1994 [1]
Net sales	$243,365	$219,496	$228,775	$252,047	$217,865
Cost of sales	100,782	94,040	95,190	110,008	98,480
Gross profit	142,583	125,456	133,585	142,039	119,385
Operating expenses:					
Selling, general and administrative [2]	56,648	49,772	47,853	45,017	41,831
Amortization of goodwill, trademarks and other intangibles	4,926	4,577	4,577	4,577	4,577
Total operating expenses	61,574	54,349	52,430	49,594	46,408
Income from operations	81,009	71,107	81,155	92,445	72,977
Other expense (income):					
Interest expense	4,817	4,362	6,063	9,582	12,629
Gain on sale of aircraft [3]	–	(2,882)	–	–	–
Other, net	(397)	(1,086)	(648)	(439)	(837)
Income before income taxes and extraordinary item	76,589	70,713	75,740	83,302	61,185
Provision for income taxes	30,073	27,932	29,796	33,737	25,086
Income before extraordinary item	46,516	42,781	45,944	49,565	36,099
Extraordinary charge due to refinancing of debt [4]	–	–	–	1,312	–
Net income	$ 46,516	$ 42,781	$ 45,944	$ 48,253	$ 36,099
Income before extraordinary item per common share assuming dilution	$ 2.45	$ 2.05	$ 2.11	$ 2.28	$ 1.67
Net income per common share assuming dilution	$ 2.45	$ 2.05	$ 2.11	$ 2.22	$ 1.67

(In thousands, except per share amounts)	Jan. 2, 1999	Jan. 3, 1998	Dec. 28, 1996	Dec. 30, 1995	Dec. 31, 1994
Working capital	$ 29,276	$ 40,857	$ 67,997	$ 36,015	$ 13,362
Total assets	233,283	259,695	285,733	259,085	239,680
Long-term debt, including current maturities	20,000	40,000	60,000	80,000	113,000
Total stockholders' equity [5]	178,735	186,655	196,757	150,286	100,305

[1] *The years ended December 31, 1994, December 30, 1995, December 28, 1996, and January 2, 1999, were 52 week periods, and the year ended January 3, 1998, was a 53-week period.*

[2] *Selling, general and administrative expenses for the year ended December 30, 1995, included $2,872 of net customs duties refunds and related interest. The refunds pertained principally to certain merchandise imported into the United States from 1989 to 1994.*

[3] *See Note 6 to the Consolidated Financial Statements.*

[4] *During February 1995, the Company entered into a credit agreement and recorded an extraordinary charge of $1,312, net of income taxes, to write off deferred financing costs.*

[5] *The Company has not declared or paid dividends on its Common Stock. The Company does not anticipate paying dividends in the foreseeable future. As a holding company, the ability of the Company to pay cash dividends will depend upon the receipt of dividends or other payments from its subsidiaries.*

RESULTS OF OPERATIONS

COMPARISON OF RESULTS OF OPERATIONS 1998 TO 1997

Net sales increased $23.9 million, or 11%, from $219.5 million in 1997 to $243.4 million in 1998. This increase was due principally to an increase in volume. Sales of Village Series products increased 13% from 1997 to 1998, while General Giftware product sales increased 7% during the same period. Village Series products continued to account for the most significant portion of the Company's sales, 65% in 1998 versus 64% in 1997.

Gross Profit increased $17.1 million, or 14%, between 1997 and 1998. Gross profit as a percentage of sales increased from 57.2% in 1997 to 58.6% in 1998, principally due to a change in the mix of product shipped during 1998 as compared to 1997 and the benefit derived from selling directly to the Canadian market.

Selling, general and administrative expenses increased $6.9 million, or 14%, between 1997 and 1998 principally due to a 45% increase in marketing expenses, a 19% increase in distribution expenses and a 6% increase in administrative expenses. Selling, general and administrative expenses as a percentage of sales was 23% in both 1997 and 1998.

Income from operations increased $9.9 million, or 14%, from 1997 to 1998 due to the factors described above. Operating margins increased from 32% of net sales in 1997 to 33% of net sales in 1998.

Interest expense increased $.5 million, or 10%, between 1997 and 1998 principally due to increased borrowings under the revolving credit agreement, offset by a decrease in interest expense from the repayment of $20 million of debt in December 1997. Borrowings under the revolving credit agreement increased as a result of the timing of stock repurchases and the increase in capital expenditures and acquisitions.

The effective income tax rate was 39.5% and 39.3% during 1997 and 1998, respectively.

COMPARISON OF RESULTS OF OPERATIONS 1997 TO 1996

Net sales decreased $9.3 million, or 4%, from $228.8 million in 1996 to $219.5 million in 1997. This decrease was due principally to a decrease in volume.

	1998		1997		1996	
(In millions, except per share amounts)	Dollars	% of Net Sales	Dollars	% of Net Sales	Dollars	% of Net Sales
Net sales	$243.4	100%	$219.5	100%	$228.8	100%
Gross profit	142.6	59	125.5	57	133.6	58
Selling, general and administrative expenses	56.6	23	49.8	23	47.9	21
Amortization of goodwill, trademarks and other intangibles	4.9	2	4.6	2	4.6	2
Income from operations	81.0	33	71.1	32	81.2	35
Interest expense	4.8	2	4.4	2	6.1	3
Gain on sale of aircraft	–	–	(2.9)	(1)	–	–
Other, net	(.4)	–	(1.1)	(1)	(.6)	–
Income before income taxes	76.6	31	70.7	32	75.7	33
Provision for income taxes	30.1	12	27.9	13	29.8	13
Net income	46.5	19	42.8	19	45.9	20
Net income per common share assuming dilution	2.45		2.05		2.11	
Operating cash flow [1]	88.7		81.7		88.1	

[1] *Operating cash flow represents earnings before interest, income taxes, depreciation and amortization. Operating cash flow is used by management and certain investors as an indicator of a company's historical ability to service debt. However, operating cash flow is not intended to represent cash flow from operations for the period, nor has it been presented as an alternative to either (i) operating income (as determined by GAAP) as an indicator of operating performance or (ii) cash flow from operating, investing and financing activities (as determined by GAAP). Operating cash flow is, therefore, susceptible to varying calculations and, as presented, may not be comparable to other similarly titled measures of other companies.*

Sales of Village Series products decreased 9% from 1996 to 1997, while General Giftware product sales increased 7% during the same period. Village Series products continued to account for the most significant portion of the Company's sales, 64% in 1997 versus 67% in 1996.

Gross Profit decreased $8.1 million, or 6%, between 1996 and 1997. Gross profit as a percentage of sales decreased from 58.4% in 1996 to 57.2% in 1997, principally due to a change in the mix of product shipped during 1997 as compared to 1996.

Selling, general and administrative expenses increased $1.9 million, or 4%, between 1996 and 1997 principally due to a 20% increase in marketing expense and a 6% increase in administrative expense, offset by a 7% decrease in commission expense. Selling, general and administrative expenses as a percentage of sales increased from approximately 21% in 1996 to approximately 23% in 1997.

Income from operations decreased $10.0 million, or 12%, from 1996 to 1997 due to the factors described above. Operating margins decreased from 35% of net sales in 1996 to 32% of net sales in 1997.

Interest expense decreased $1.7 million, or 28%, between 1996 and 1997 principally due to the repayment of $20 million of debt in December 1996.

During December 1997, the Company exercised its purchase option under an aircraft lease agreement and subsequently sold the aircraft to a former officer of the Company for $8.6 million, its appraised value, recognizing a gain of $2.9 million.

The effective income tax rate was 39.3% and 39.5% during 1996 and 1997, respectively.

SEASONALITY

Historically, principally due to the timing of wholesale trade shows early in the calendar year and the limited supply of the Company's products, the Company has received the majority of its total annual customer orders during the first quarter of each year. The Company entered 65% and 66% of its total annual customer orders for 1998 and 1997, respectively, during the first quarter of each of those years. Cancellations of total annual customer orders were approximately 7% and 8% in 1998 and 1997, respectively. The Company's backlog was $4.0 million and $4.6 million at January 2, 1999 and January 3, 1998, respectively.

The Company shipped and recorded as net sales approximately 91% and 90% of its annual customer orders in 1998 and 1997, respectively. Orders not shipped in a particular year, net of cancellations, returns, allowances and cash discounts, are carried into backlog for the following year and have historically been orders for Spring and Easter products.

The Company receives products, pays its suppliers and ships products throughout the year, although historically

	1998					1997				
(In millions, except per share amounts)	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total
Customer orders entered [1]	$173.7	$50.0	$37.1	$ 7.7	$268.5	$160.6	$43.8	$34.3	$ 6.2	$244.9
Net sales	49.0	69.9	71.5	52.9	243.4	45.7	58.6	61.6	53.6	219.5
Gross profit	28.4	41.2	41.7	31.2	142.6	26.6	33.9	35.8	29.2	125.5
Selling, general and administrative expenses	11.6	13.6	14.3	17.1	56.6	10.7	11.4	12.1	15.6	49.8
Amortization of goodwill, trademarks and other intangibles	1.2	1.3	1.3	1.3	4.9	1.1	1.1	1.2	1.2	4.6
Income from operations	15.7	26.3	26.1	12.9	81.0	14.7	21.3	22.5	12.6	71.1
Net income	9.2	15.4	15.0	6.9	46.5	8.7	12.4	13.1	8.6	42.8
Net income per common share assuming dilution [2]	0.47	0.80	0.81	0.38	2.45	0.40	0.59	0.63	0.42	2.05

[1] *Customer orders entered are orders received and approved by the Company, subject to cancellation for various reasons including credit considerations, inventory shortages and customer requests.*

[2] *See Note 11 to the Consolidated Financial Statements.*

the majority of shipments occur in the second and third quarters as retailers stock merchandise in anticipation of the holiday season. As a result of this seasonal pattern, the Company generally records its highest sales during the second and third quarters of each year. The Company expects this seasonal pattern to continue for the foreseeable future. The Company can experience fluctuations in quarterly sales growth and related net income compared with the prior year due to the timing of receipt of product from suppliers and subsequent shipment of product from the Company to customers, as well as the timing of orders placed by customers. The Company is not managed to maximize quarter-to-quarter results, but rather to achieve broader, long-term growth objectives which are consistent with the Company's business strategy.

LIQUIDITY AND CAPITAL RESOURCES

In March 1999, the Company entered into a new credit agreement providing a $100 million revolving credit facility and a $150 million revolver/term loan. The $150 million revolver/term loan converts to a four-year term loan after one year. The revolver/term loan will have annual amortization payments of 15%, 20%, 25% and 40% of the amount outstanding at conversion in March 2001, 2002, 2003 and 2004, respectively.

The Company used the proceeds of the revolver/term loan to refinance the remaining $20 million term loan under its former credit agreement. In connection therewith, the Company recorded $1,700,000 in deferred financing fees, which will be amortized over the life of the credit agreement.

The revolving credit facility provides for borrowings of up to $100 million including letters of credit. The letters of credit are issued primarily in connection with inventory purchases. The credit agreement contains financial and operating covenants, including restrictions on incurring indebtedness and liens, selling property and paying dividends. In addition, the Company is required to satisfy consolidated net worth, interest coverage ratio and leverage ratio tests, in each case at the end of each fiscal quarter.

The Company believes that its internally generated cash flow and seasonal borrowings under the revolving credit facility will be adequate to fund operations and capital expenditures for the next twelve months.

Consistent with customary practice in the giftware industry, the Company offers extended accounts receivable terms to many of its customers. This practice has typically created significant working capital requirements in the second and third quarters which the Company has generally financed with available cash, internally generated cash flow and seasonal borrowings. The Company's cash and cash equivalents balances peak in December, following the collection in November and December of accounts receivable with extended payment terms. The Company's bad debt experience relating to these accounts receivable has not been material.

Accounts receivable increased from $23.0 million at January 3, 1998 to $26.2 million at January 2, 1999, principally due to the increase in net sales in 1998 as compared to 1997.

Capital expenditures were $6.8 million, $7.8 million and $1.5 million for 1998, 1997 and 1996, respectively. Included in 1997 capital expenditures is $4.9 million in connection with the Company's exercise of a purchase option under its aircraft lease agreement. See Note 6 to the Consolidated Financial Statements. Included in 1998 capital expenditures is $4.1 million in connection with the implementation of a new information system. The new information system will significantly update the Company's current information system capabilities and is expected to eliminate Year 2000 issues for the Company's primary business systems.

During 1998, the Company acquired substantially all of the assets of the independent sales representative organizations that represented the Company's products in California and several surrounding western states and New York and several surrounding eastern states. Also during 1998, the Company acquired the inventory and certain other assets of its Canadian distributor. The cost of these acquisitions was $4.7 million.

In January 1999, the Company entered into a letter of intent with a contractor to lease a proposed distribution center in Minnesota. The Company plans to consolidate its three current distribution centers into the proposed distribution center by the end of 1999. The anticipated term of the lease will be approximately ten years with options to renew the lease. The proposed lease payments will approximate the combined lease payments of the Company's three current distribution centers.

Operating cash flow, defined as earnings before interest, income tax, depreciation and amortization expenses, increased $7.0 million, or 9%, from $81.7 million in 1997 to $88.7 million in 1998. The increase was principally due to the increase in net income.

The Company has a stock repurchase program. In 1998, the Board of Directors of the Company authorized the repurchase in open market and privately negotiated transactions of up to an additional 1.5 million shares valid through the end of the Company's 1999 fiscal year. The timing, prices and amounts of shares repurchased will be determined at the discretion of the Company's management and subject to continued compliance with the Company's credit facilities. Under this program, the Company repurchased in the open market 1.7 million shares during 1998 at a weighted-average price of $35 per share. The Company is authorized to repurchase an additional 0.6 million shares through the end of 1999.

YEAR 2000

On January 3, 1999, the Company substantially implemented a new integrated computer system, which replaced its primary operating and financial computing systems. The vendor of the core software program for the new integrated system has indicated that this system will substantially address Year 2000 requirements, and the Company does not anticipate that it will experience any material disruption to its transaction processing operations or financial or accounting functions as a result of the failure of any of its systems to be Year 2000 compliant. The Company is continuing to monitor and evaluate its new and existing systems so that, in the event substantial non-compliance with Year 2000 needs is detected, the remainder of 1999 can be utilized to achieve necessary functionality.

Total expenditures (aside of internal labor costs) for implementation of the new system is expected to be approximately $5 million, of which approximately $4 million has been incurred as of January 2, 1999. Hardware, software and certain project costs were capitalized and will be amortized over their useful lives. All other costs were expensed as incurred.

The Company believes that the implementation of the new integrated computer system will allow it to be substantially Year 2000 compliant. There can be no assurance, however, that the systems of third parties on which the Company relies will be Year 2000 compliant in a timely manner. As a precautionary measure, the Company intends to develop contingency plans for all of its systems that are not expected to be Year 2000 compliant by October 1999. A variety of automated as well as manual fallback plans will be considered, including the use of electronic spreadsheets, resetting system dates and manual workarounds. An interruption of the Company's ability to conduct its business due to a Year 2000 problem with a third party could have a material adverse effect on the Company. The Company's product vendor and customer bases are fragmented, and generally are not dependent on computer control or systematization of their business operations. Management, therefore, believes that the greatest risks presented by potential Year 2000 failures of third parties are those which would affect the general economy or certain industries, such as may occur if there were insufficient electric power or other utilities needed for the Company's operations or manufacture of its products or insufficient reliable means of transporting the Company's products. While such failures could affect important operations of the Company, either directly or indirectly, in a significant manner, the Company cannot at present estimate either the likelihood or the potential cost of such failures. The statements concerning future matters are "forward-looking statements" and actual results may vary.

FOREIGN EXCHANGE

The dollar value of the Company's assets abroad is not significant. Substantially all of the Company's sales are denominated in U.S. dollars and, as a result, are not subject to changes in exchange rates.

The Company imports its product from manufacturers located in the Pacific Rim, primarily China, Taiwan (Republic of China) and The Philippines. These transactions are principally denominated in U.S. dollars, except for imports from Taiwan which are principally denominated in New Taiwan dollars. The Company, from time to time, will enter into foreign exchange contracts or build foreign currency deposits as a partial hedge against currency fluctuations. The Company intends to manage foreign exchange risks to the extent possible and take appropriate action where warranted. The Company's costs could be adversely affected if the currencies of the countries in which the manufacturers operate appreciate significantly relative to the U.S. dollar.

EFFECT OF INFLATION

The Company continually attempts to minimize any effect of inflation on earnings by controlling its operating costs and selling prices. During the past few years, the rate of inflation has been low and has not had a material impact on the Company's results of operations.

RECENT DEVELOPMENTS

On February 24, 1999, the Company issued a press release stating in relevant part: "Based on orders received to date ... we expect that the increase in our full first quarter orders will be consistent with achieving our goal of seven to nine percent sales growth and mid-teen earnings per share growth in 1999. Our confidence is underscored by recent dealer feedback indicating that retail sales for our collectible products grew in 1998 and inventory turnover improved." The press release also noted that in January 1999, "the company installed a new integrated enterprise-wide software system. While this new system will be a valuable asset in facilitating future growth, the installation has changed the timing of the receipt of orders from customers and product shipping, thereby impacting comparability to prior years' levels. However this should not impact full-year results."

The press release further stated: "Department 56 initiated a number of steps in 1998 to help position the company for strong future growth, including launching the first new Village line in five years, successfully broadening existing lines and investing in new marketing and product development resources. During [1999, the Company] will continue to invest our strong cash flow in new growth opportunities, including launching new products, building our brand through the opening of our first company-owned store at the Mall of America in May, consolidating our warehouses into a new facility and exploring attractive acquisition opportunities."

On Form 8-K dated February 26, 1999, the Company stated: "In addition to the statements contained in the press release, the Company expects that its effective income tax rate for fiscal year 1999 may decrease by up to 1 percentage point from the 39.3% rate experienced in fiscal year 1998."

The federal securities laws provide "safe harbor" status to certain statements that go beyond historical information and which may provide an indication of future results. Any conclusions or expectations drawn from the statements in the press release or the Form 8-K or throughout this annual report concerning matters that are not historical corporate financial results are "forward-looking statements" that involve risks and uncertainties.

The Company's first quarter 1999 order expectations and sales expectations for 1999 are based on the Company's current forecast of dealer orders and planned sales at the retail store it plans to open in May 1999, and is further dependent on the timing and extent of promotional and marketing efforts undertaken by the Company as well as the timing and extent of product receipts and shipments, the efficiency of information systems developed to collect, compile and execute customer orders, and retailer and consumer demand. Dealer orders are principally dependent on the amount, quality and market acceptance of the new product introductions and retailer demand. Dealer order patterns have historically varied in number, mix and timing, and there can be no assurance that the order trend experience from January 3, 1999, through February 24, 1999, will continue. The Company's expectations regarding earnings per share are based on the Company's sales expectations and assume it will maintain its historical operating margin. The Company's operating margin may be impacted by, amongst other factors, shifts in product mix; exchange rate fluctuations with countries the Company imports from; changes in ocean freight rates; and changes in the Company's historical selling, general and administrative expense rate. Moreover, the statements in the press release or the Form 8-K or throughout this annual report concerning retail inventory levels, consumer demand and dealer expectations are based on statistical research conducted by or for the Company, and assume that such findings are correct and representative of market conditions as a whole.

Readers are cautioned that actual effective tax rates are dependent upon numerous factors, and that the Company's expectation concerning the 1999 effective tax rate assumes realization of fiscal year 1999 sales expectations and fiscal year 1999 operating margin assumptions referred to in the press release. In addition, the factors which may impact sales, operating margin or earnings stated in the press release can significantly impact the Company's effective income tax rate.

If not mentioned above, other factors, including consumer acceptance of new products; product development efforts; identifications and retention of sculpting and other talent; completion of third party product manufacturing; dealer reorders and order cancellations; control of operating expenses; corporate cash flow application, including share repurchases; functionality of information and operating systems; identification, completion and results of acquisitions, investments and other strategic business initiatives; grants of stock options or other equity equivalents; actual or deemed exercises of stock options; and industry, general economic, regulatory, transportation and international trade and monetary conditions, can significantly impact the Company's sales, earnings and earnings per share. Actual results may vary materially from forward-looking statements and the assumptions on which they are based. The Company undertakes no obligation to update or publish in the future any forward-looking statements.

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)	January 2, 1999	January 3, 1998
Current Assets:		
Cash and cash equivalents	$ 2,783	$ 37,361
Accounts receivable, net of allowances of $12,908 and $13,057, respectively	26,170	23,004
Inventories	18,287	18,070
Deferred taxes	6,704	6,303
Other current assets	3,957	3,008
Total current assets	57,901	87,746
Property and equipment, net	17,722	12,753
Goodwill, net of accumulated amortization of $25,862 and $21,683, respectively	141,528	143,491
Trademarks and other intangibles, net of accumulated amortization of $3,097 and $2,349, respectively	16,003	15,551
Other assets	129	154
	$ 233,283	$ 259,695
Current Liabilities:		
Current portion of long-term debt	$ –	$ 20,000
Accounts payable	11,100	9,973
Commissions payable	3,062	3,955
Other current liabilities	14,463	12,961
Total current liabilities	28,625	46,889
Deferred taxes	5,923	6,151
Long-term debt	20,000	20,000
Commitments and contingencies (Note 6)		
Stockholders' Equity:		
Preferred stock, $.01 par value; authorized 20,000 shares; no shares issued	–	–
Common stock, $.01 par value; authorized 100,000 shares; issued and outstanding 21,900 and 21,765 shares, respectively	219	218
Additional paid-in capital	48,295	44,645
Treasury stock, at cost; 3,876 and 2,199 shares, respectively	(113,302)	(55,215)
Retained earnings	243,523	197,007
Total stockholders' equity	178,735	186,655
	$ 233,283	$ 259,695

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts)	Year Ended January 2, 1999	Year Ended January 3, 1998	Year Ended December 28, 1996
Net sales	$ 243,365	$ 219,496	$ 228,775
Cost of sales	100,782	94,040	95,190
Gross profit	142,583	125,456	133,585
Operating expenses:			
Selling, general and administrative	56,648	49,772	47,853
Amortization of goodwill, trademarks and other intangibles	4,926	4,577	4,577
Total operating expenses	61,574	54,349	52,430
Income from operations	81,009	71,107	81,155
Other expense (income):			
Interest expense	4,817	4,362	6,063
Gain on sale of aircraft	–	(2,882)	–
Other, net	(397)	(1,086)	(648)
Income before income taxes	76,589	70,713	75,740
Provision for income taxes	30,073	27,932	29,796
Net income	$ 46,516	$ 42,781	$ 45,944
Net income per common share	$ 2.49	$ 2.06	$ 2.13
Net income per common share assuming dilution	$ 2.45	$ 2.05	$ 2.11

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)	Year Ended January 2, 1999	Year Ended January 3, 1998	Year Ended December 28, 1996
Cash Flows from Operating Activities:			
Net income	$ 46,516	$ 42,781	$ 45,944
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	2,385	2,031	1,721
Amortization of goodwill, trademarks and other intangibles	4,926	4,577	4,577
Provision for uncollectible accounts receivable	888	1,087	2,014
Gain on sale of aircraft	–	(2,882)	–
Compensation expense – common stock options	–	–	14
Deferred taxes	(629)	(2,774)	(37)
Changes in assets and liabilities:			
Accounts receivable	(4,054)	11,512	(3,349)
Inventories	186	2,456	8,533
Other assets	(961)	(1,337)	502
Accounts payable	1,127	2,355	1,019
Commissions payable	(893)	(728)	212
Other current liabilities	2,582	4,882	(1,379)
Net cash provided by operating activities	52,073	63,960	59,771
Cash Flows from Investing Activities:			
Purchases of property and equipment	(6,750)	(7,829)	(1,507)
Proceeds from sale of aircraft	–	8,567	–
Acquisitions	(4,660)	–	–
Net cash provided by (used in) investing activities	(11,410)	738	(1,507)
Cash Flows from Financing Activities:			
Proceeds from the exercise of common stock options	2,846	1,473	336
Borrowings on revolving credit agreement	75,500	17,985	34,338
Principal payments on revolving credit agreement	(75,500)	(17,985)	(34,338)
Purchases of treasury stock	(58,087)	(55,215)	–
Principal payments on long-term debt	(20,000)	(20,000)	(20,000)
Net cash used in financing activities	(75,241)	(73,742)	(19,664)
Net increase (decrease) in cash and cash equivalents	(34,578)	(9,044)	38,600
Cash and cash equivalents at beginning of period	37,361	46,405	7,805
Cash and cash equivalents at end of period	$ 2,783	$ 37,361	$ 46,405

See Notes to Consolidated Financial Statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In thousands)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Unearned Compensation on Common Stock Options	Treasury Stock	Retained Earnings	Total Stockholders' Equity
Balance as of December 30, 1995	21,546	$215	$41,803	$(14)	$ –	$108,282	$150,286
Net income	–	–	–	–	–	45,944	45,944
Shares issued upon the exercise of common stock options	38	1	512	–	–	–	513
Common stock options vested	–	–	–	14	–	–	14
Balance as of December 28, 1996	21,584	216	42,315	–	–	154,226	196,757
Net income	–	–	–	–	–	42,781	42,781
Shares issued upon the exercise of common stock options	181	2	2,330	–	–	–	2,332
Shares repurchased	(2,199)	–	–	–	(55,215)	–	(55,215)
Balance as of January 3, 1998	19,566	218	44,645	-	(55,215)	197,007	186,655
Net income	–	–		–	–	46,516	46,516
Shares issued upon the exercise of common stock options	131	1	3,541	–	–	–	3,542
Shares repurchased	(1,677)	–	–	–	(58,087)	–	(58,087)
Other	3	–	109	–	–	–	109
Balance as of January 2, 1999	18,023	$219	$48,295	$ –	$(113,302)	$243,523	$178,735

See Notes to Consolidated Financial Statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share amounts)

1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Company is engaged in the original design, importation and wholesale distribution of specialty giftware products. The majority of the Company's products are developed and designed by the Company's in-house creative team and are manufactured for the Company by independently owned foreign manufacturers located primarily in the Pacific Rim. The Company's customer base and accounts receivable are primarily comprised of, and are due from, retail stores of various sizes located throughout the United States and Canada.

The accompanying consolidated financial statements of the Company include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

The Company's policy is to end its fiscal year on the Saturday closest to December 31. The years ended January 2, 1999, and December 28, 1996, include 52 weeks, and the year ended January 3, 1998, includes 53 weeks.

All highly liquid debt instruments with original maturities of three months or less are considered to be cash equivalents and are reported as cash and cash equivalents on the consolidated balance sheets.

Inventories consist of finished goods and are stated at the lower of average cost, which approximates first-in, first-out cost, or market value. The Company records inventory at the date of taking title, which at certain times during the year results in significant in-transit quantities, as inventory is sourced primarily from China, Taiwan and other Pacific Rim countries. Each period the Company provides for identified, unsalable and slow moving inventory.

Property and equipment are stated at cost. Depreciation is computed on a straight-line method over the estimated useful lives of the assets, ranging from 2 to 45 years.

Major improvements and replacements of property are capitalized. Maintenance, repairs and minor improvements are expensed. Upon retirement or other disposition of property, applicable cost and accumulated depreciation are removed from the accounts. Any gains or losses are included in earnings.

Goodwill represents the excess of cost over the fair value of acquired net assets of the Company at the acquisition date and is being amortized on a straight-line basis over 30 to 40 years. The Company periodically evaluates the recoverability of goodwill based on an analysis of estimated future undiscounted cash flows.

Trademarks and other intangible assets acquired are being amortized on a straight-line basis over 3 to 40 years. The Company periodically evaluates the recoverability of trademarks based on an analysis of estimated future undiscounted cash flows.

Revenues are recognized when products are shipped, net of an allowance for returns.

Deferred income taxes are recognized for the tax consequences in future years of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year end based on enacted tax laws and statutory tax rates applicable to the periods in which the differences are expected to affect taxable income.

The Company uses the United States dollar as the functional currency of its foreign operations. Accordingly, translation gains and losses resulting from the remeasurement of foreign operations' financial statements are reflected in the accompanying statements of income.

The Company imports most of its products and, while the majority of these purchases are denominated in U.S. dollars, some of the purchases are denominated in foreign currency. In addition, the Company's sales to Canada are denominated in Canadian dollars. To hedge its foreign exchange exposure, the Company may enter into foreign exchange contracts. The foreign exchange contracts reduce the Company's overall exposure to exchange rate movements, since the gains and losses on these contracts offset gains and losses on the transactions being hedged. Gains or losses on these contracts will be recognized and included in cost of sales at the time the related inventory is sold. The Company is exposed to credit risk to the extent of nonperformance by a counterparty to the foreign currency contracts. However, the Company believes it uses a strong financial counterparty in these transactions and that the resulting credit risk under these hedging strategies is not significant.

The carrying amount of cash and cash equivalents, accounts receivable, accounts payable and commissions payable approximates fair value because of the short-term nature of these instruments. Based on the borrowing rates currently available to the Company for bank loans with similar terms and maturities, the Company also believes the carrying amount of long-term debt approximates fair value. The fair value of the Company's forward currency contracts is determined using the current spot rate. There were no forward currency contracts outstanding at January 3, 1998, and January 2, 1999.

Net income per common share is calculated by dividing net income by the weighted-average number of shares outstanding during the period. Net income per common share assuming dilution reflects per share amounts that would have resulted had the Company's outstanding stock options been converted to common stock. See Note 11.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(In thousands, except share and per share amounts)

Certain reclassifications were made to the fiscal 1997 and 1996 consolidated financial statements in order to conform to the presentation of the fiscal 1998 consolidated financial statements. These reclassifications had no impact on net income or retained earnings as previously reported.

In June 1997, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 130, *Reporting Comprehensive Income*. Comprehensive income includes net income and several other items that current accounting standards require to be recognized outside of net income. This standard requires enterprises to display comprehensive income and its components in financial statements; to classify items of comprehensive income by their nature in financial statements; and to display the accumulated balances of other comprehensive income in stockholders' equity separately from retained earnings and additional paid-in capital. The Company adopted SFAS No. 130 in fiscal 1998, and there were no items of other comprehensive income for all periods presented.

In June 1997, the FASB issued SFAS No. 131, *Disclosure about Segments of an Enterprise and Related Information*, replacing SFAS No. 14 and its amendments. This standard requires enterprises to report certain information about products and services, activities in different geographic areas and reliance on major customers, and to disclose certain operating segment information in their financial statements. Operating segments are components of an enterprise for which financial information is available and evaluated by the enterprise's chief operating decision-maker in allocating resources and assessing performance. The Company adopted SFAS No. 131 in fiscal 1998. The Company has determined that it operates in one segment, specialty giftware. In addition, less than 3% of total revenue is derived from customers outside the United States and less than 1% of all long lived assets are located outside the United States. No customer represents more than 3% of total revenue.

Effective January 4, 1998, the Company adopted Statement of Position (SOP) No. 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. SOP No. 98-1 provides guidance on accounting for costs associated with computer software developed or obtained for internal use. Adoption of this standard did not have a significant effect on the financial results of the Company.

During 1998, the FASB issued SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, which is effective for years beginning after June 15, 1999. The Company is currently evaluating the impact, if any, of this statement.

2 PROPERTY AND EQUIPMENT

Property and equipment is comprised of the following:

	Jan. 2, 1999	Jan. 3, 1998
Leasehold improvements	$ 3,026	$ 1,253
Furniture and fixtures	2,585	1,758
Computer equipment	8,495	4,646
Other equipment	5,175	4,804
Building	6,764	6,288
Land	906	906
	26,951	19,655
Less accumulated depreciation	9,229	6,902
Property and equipment, net	$17,722	$12,753

3 OTHER CURRENT LIABILITIES

Other current liabilities are comprised of the following:

	Jan. 2, 1999	Jan. 3, 1998
Accrued compensation and benefits	$4,698	$3,377
Income taxes payable	7,768	7,644
Deferred revenue	754	679
Accrued royalty fees	578	570
Other	665	691
	$14,463	$12,961

4 CREDIT AGREEMENT

Long-term debt is comprised of the following:

	Jan. 2, 1999	Jan. 3, 1998
Term loan	$20,000	$40,000
Less current portion	–	20,000
	$20,000	$20,000

(In thousands, except share and per share amounts)

In March 1999, the Company entered into a new credit agreement providing a $100 million revolving credit facility and a $150 million revolver/term loan. The $150 million revolver/term loan converts to a four-year term loan after one year. The revolver/term loan will have annual amortization payments of 15%, 20%, 25% and 40% of the amount outstanding at conversion in March 2001, 2002, 2003 and 2004, respectively.

The Company used the proceeds of the revolver/term loan to refinance the remaining $20 million term loan under its former credit agreement. As of January 2, 1999, the $20 million term loan has been classified as noncurrent to reflect the refinancing. In connection therewith, the Company recorded $1,700 in deferred financing fees, which will be amortized over the life of the credit agreement.

The revolving line of credit provides for borrowings of up to $100,000, which may be in the form of letters of credit, bankers acceptances and revolving credit loans. The sum of the Company's revolving credit loans and bankers acceptances may not exceed an aggregate of $30,000 during any one 30 consecutive day period each calendar year. Borrowings under the credit agreement are subject to certain borrowing base limitations (as defined). The revolving line of credit provides for commitment fees of 0.25% to 0.50% per annum on the daily average of the unused commitment.

The credit agreement allows the Company to choose between two interest rate options in connection with its term loan and revolving credit loans. The interest rate options are the Alternate Base Rate (as defined) or the Eurodollar Rate (as defined) plus an applicable margin. The applicable margin ranges from 0.875% to 1.625% for Eurodollar Rate loans. The credit agreement expires March 19, 2004.

The credit agreement includes restrictions as to, among other things, the amount of additional indebtedness, liens, contingent obligations, investments and dividends. The credit agreement also requires maintenance of minimum levels of interest coverage, net worth and maximum levels of leverage.

None of these restrictions are expected to have a material adverse effect on the Company's ability to operate in the future. The Company has pledged the common stock of its subsidiaries, direct and indirect, as collateral under the credit agreement, and the Company and its subsidiaries, direct and indirect, have guaranteed repayment of amounts borrowed under the credit agreement.

The Company paid interest of $4,859, $4,400 and $6,129 during the years ended January 2, 1999, January 3, 1998, and December 28, 1996, respectively.

5 INCOME TAXES

The provision for income taxes consisted of the following:

	Year Ended Jan. 2, 1999	Year Ended Jan. 3, 1998	Year Ended Dec. 28, 1996
Current:			
Federal	$28,188	$28,225	$27,376
State	2,416	2,419	2,347
Foreign	98	62	110
Deferred	(629)	(2,774)	(37)
	$30,073	$27,932	$29,796

The reconciliation between income tax expense based on statutory income tax rates and the provision for income taxes per the consolidated statements of income is as follows:

	Year Ended Jan. 2, 1999	Year Ended Jan. 3, 1998	Year Ended Dec. 28, 1996
Income taxes at federal statutory rate	$26,806	$24,750	$26,509
State income taxes, net of federal income tax	1,915	1,768	1,893
Amortization of goodwill	1,448	1,448	1,448
Other	(96)	(34)	(54)
Provision for income taxes	$30,073	$27,932	$29,796

(In thousands, except share and per share amounts)

The components of the net deferred tax asset were as follows:

	Jan. 2, 1999	Jan. 3, 1998
Deferred tax assets:		
Accounts receivable valuation allowances	$ 4,793	$ 4,660
Inventory valuation allowances	1,638	1,469
Compensation expense – common stock options	121	141
Accrued liabilities	400	264
Other	172	220
Total deferred tax assets	7,124	6,754
Deferred tax liabilities:		
Trademarks	(5,739)	(5,909)
Property and equipment	(379)	(440)
Other	(225)	(253)
Total deferred tax liabilities	(6,343)	(6,602)
	$ 781	$ 152

The $781 net deferred tax asset at January 2, 1999, is presented as a net deferred current asset of $6,704 and a net deferred noncurrent liability of $5,923. The $152 net deferred tax asset at January 3, 1998, is presented as a net deferred current asset of $6,303 and a net deferred noncurrent liability of $6,151.

The Company paid income taxes of $29,829, $28,134 and $28,943 during the years ended January 2, 1999, January 2, 1998, and December 28, 1996, respectively.

6 COMMITMENTS AND CONTINGENCIES

The Company leases warehouse and office space, equipment and showroom display facilities under renewable operating leases ranging from three to twelve years in duration. In addition to the base rent, the Company pays its proportionate share of taxes and special assessments and operating expenses of the warehouse and showroom display facilities.

The following is a schedule of future annual minimum lease payments for noncancelable operating leases as of January 2, 1999:

1999	$ 2,836
2000	2,366
2001	1,703
2002	1,246
2003	1,013
Thereafter	3,273
	$12,437

The Company's rental expense was $2,533, $2,934 and $3,238 for the years ended January 2, 1999, January 3, 1998, and December 28, 1996, respectively.

In January 1999, the Company entered into a letter of intent with a contractor to lease a proposed distribution center in Minnesota. The Company plans to consolidate its three current distribution centers into the proposed distribution center by the end of 1999. The anticipated term of the lease will be approximately ten years with options to renew the lease. The proposed lease payments will approximate the combined lease payments of the Company's three current distribution centers. The proposed lease payments are not included in the schedule of future annual minimum lease payments above.

During December 1997, the Company exercised its purchase option under an aircraft lease agreement and subsequently sold the aircraft at its appraised value to a former officer of the Company for $8,567, recognizing a gain of $2,882.

The Company had outstanding standby and commercial letters of credit amounting to $2,677 at January 2, 1999 relating primarily to purchase commitments issued to foreign suppliers and vendors.

The Company is involved in various legal proceedings, claims and governmental audits in the ordinary course of its business. In the opinion of the Company's management, the ultimate disposition of these proceedings, claims and audits will not have a material adverse effect on the financial position or results of operations of the Company.

7 RETIREMENT PLAN

The Company has a profit sharing plan covering substantially all employees. Contributions to this plan are at the discretion of the Board of Directors, subject to certain limitations. Charges in respect to the Company's profit sharing contributions were $1,025, $1,136 and $750 for the years ended January 2, 1999, January 3, 1998, and December 28, 1996, respectively.

8 ACQUISITIONS

During 1998, the Company acquired substantially all of the assets of the independent sales representative organizations that represented the Company's products in California and several surrounding western states and New York and several surrounding eastern states. Also during 1998, the Company acquired the inventory and certain other assets of its Canadian distributor. The cost of these acquisitions was $4.7 million, and was accounted for using the purchase method of accounting. Goodwill recorded as a result of these transactions was $3.4 million

9 RELATED-PARTY TRANSACTIONS

In the ordinary course of business, the Company sells product to a floral and nursery wholesaler and retailer, of which a former director of the Company is an officer, director and stockholder. The Company had sales to this floral and nursery business during the years ended January 2, 1999, January 3, 1998, and December 28, 1996, of $1,448, $1,323 and $1,305, respectively.

During the years ended January 3, 1998, and December 28, 1996, the Company paid $1,343 and $2,116 respectively, for aircraft management, transportation and other expenses to an affiliate of a former director of the Company.

During 1997, the Company was reimbursed $467 by a former director and officer of the corporation for use of the Company's aircraft.

On November 10, 1997, the Company purchased 250,000 shares of its common stock from a former director and officer of the Company at a price per share equal to the closing price in consolidated trading on that day.

(In thousands, except share and per share amounts)

10 STOCKHOLDERS' EQUITY

At January 2, 1999, the Company had four stock-based compensation plans. Under the 1992, 1993, 1995 and 1997 stock option plans, the Company may grant options to its directors, officers, employees, consultants and advisors of the Company for up to 292,500, 1,000,000, 600,000 and 1,500,000 shares of common stock, respectively. All employee options granted after the initial public offering have an exercise price equal to the market value of the common stock at the date of grant, generally have a term of 10 years, and generally are exercisable in equal installments on each of the first, second and third anniversaries of the date of the grant. At January 2, 1999, the shares available for granting under the 1992, 1993, 1995 and 1997 stock option plans were 7,333, 69,332, 88,651 and 1,022,572 shares, respectively.

A summary of the status of the Company's four stock option plans as of January 2, 1999, January 3, 1998, and December 28, 1996, and changes during the years ended on those dates is presented below:

The Company applies Accounting Principle's Board Opinion No. 25, *Accounting for Stock Issued to Employees,* and related interpretations in accounting for its plans. Accordingly, no compensation cost has been recognized for options granted since the initial public offering. Had compensation cost been determined based on the fair value of the 1996, 1997 and 1998 stock option grants consistent with the method of SFAS No. 123, *Accounting for Stock-Based Compensation*, the Company's net income and net income per common share assuming dilution would have been reduced to the pro forma amounts indicated below:

	1998	1997	1996
As reported	$46,516	$42,781	$45,944
Pro forma	$44,223	$40,245	$43,410
As reported	$2.45	$2.05	$2.11
Pro forma	$2.33	$1.93	$2.00

In determining the preceding pro forma amounts under SFAS 123, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 1998, 1997 and 1996, respectively: expected volatility of 38, 38 and 46 percent; risk-free interest rates of 5.2 percent, 6.2 percent and 5.8 percent; expected lives of 6 years; and no expected dividends. The effects of applying SFAS 123 in this pro forma disclosure are not indicative of future compensation costs. SFAS 123 does not apply to awards prior to 1995, and additional awards are anticipated.

	1998		1997		1996	
Stock Options	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise-Price
Outstanding at beginning of year	1,983,578	$26.25	1,291,908	$27.51	1,072,773	$31.73
Granted	97,000	31.87	806,000	23.07	433,350	20.48
Exercised	(129,625)	21.90	(85,415)	13.53	(33,500)	9.36
Forfeited	(226,596)	26.94	(28,915)	31.93	(180,715)	39.09
Outstanding at end of year	1,724,357	26.80	1,983,578	26.25	1,291,908	27.51
Options exercisable at end of year	1,085,026	28.95	798,258	30.43	536,583	28.09
Weighted-average fair value of options granted during the year	$14.89		$10.96		$10.75	

(In thousands, except share and per share amounts)

The following table summarizes information about the Company's stock option plans at January 2, 1999:

Range of Exercise Prices	Number Outstanding at Jan. 2, 1999	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable at Jan. 2, 1999	Weighted-Average Exercise Price
$ 3.33	41,013	3.1 years	$ 3.33	41,013	$ 3.33
18.00–21.47	907,830	7.9	20.94	403,583	20.70
21.48–37.75	775,514	6.8	34.90	640,430	35.79
	1,724,357			1,085,026	

In addition to stock options granted under the Company's stock option plans, the Company granted options to purchase 30,000 shares of Common Stock to each of four members of the Company's Board of Directors in December 1992. During February 1993, the Company granted options to purchase 30,000 shares of Common Stock to one member of the Board of Directors. These options are not subject to a stock option plan. Such options are exercisable, have a term of ten years from the date of grant, and have an exercise price of $3.33 per share. During 1998, 1997 and 1996, members of the Board of Directors exercised 2,000, 95,000 and 5,000 options, respectively. At January 2, 1999, directors options to purchase 38,000 shares of Common Stock were exercisable at $3.33 per share.

In April 1997, the Company adopted a shareholder rights plan. Under the shareholder rights plan, each shareholder received a dividend of one preferred share purchase right for each share held of the Company's common stock. Each right entitles the holder to purchase one one-thousandth of a share of Series A Participating Preferred Stock at an exercise price of $100, subject to adjustment, or at the discretion of the Board of Directors of the Company, the right to purchase common stock of the Company at a 50% discount. The rights become exercisable only upon the occurrence of certain events involving a buyer acquiring 18.5% or greater beneficial ownership in the Company's common stock or the announcement of a tender offer or exchange offer which, if consummated, would give the buyer beneficial ownership of an 18.5% or greater position in the Company. Preferred share purchase rights owned by the buyer become null and void following this occurrence. The rights will expire April 2007, and the Company may redeem the rights at any time (prior to the occurrence of a specified event) at a price of one cent per right. If the Company is acquired in a merger or similar transaction after such an occurrence, all rights holders, except the buyer, will have the right to purchase stock in the buyer at a 50% discount.

11 INCOME PER COMMON SHARE

The following tables reconcile net income per common share and net income per common share assuming dilution:

	1998	1997	1996
Net income	$46,516	$42,781	$45,944
Weighted-average number of shares outstanding	18,676,000	20,744,000	21,560,000
Net income per common share	$2.49	$2.06	$2.13

	1998	1997	1996
Net income	$46,516	$42,781	$45,944
Weighted-average number of shares outstanding	18,676,000	20,744,000	21,560,000
Dilutive impact of options outstanding	284,000	152,000	199,000
Weighted-average number of shares and potential dilutive shares outstanding	18,960,000	20,896,000	21,759,000
Net income per common share assuming dilution	$2.45	$2.05	$2.11

Options to purchase 662,000 shares of common stock at exercise prices between $34 and $38 per share were outstanding at January 2, 1999, but were not included in the computation of net income per common share assuming dilution because the options exercise prices were greater than the average market price of the common stock.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

Management is responsible for the preparation and accuracy of the consolidated financial statements and other information included in this report. The consolidated financial statements have been prepared in conformity with generally accepted accounting principles using, where appropriate, management's best estimates and judgments.

The Company maintains an internal control structure that is adequate to provide reasonable assurance that the assets are safeguarded from loss or unauthorized use. This structure produces records adequate for preparation of financial information. We believe the Company's internal control structure is effective, and the cost of the internal control structure does not exceed the benefits obtained.

The Board of Directors reviews the financial statements and reporting practices of the Company through its Audit Committee, which is composed entirely of directors who are not officers or employees of the Company. The Audit Committee meets with the independent auditors and management to discuss audit scope and results and to consider internal control and financial reporting matters. The independent auditors have direct unrestricted access to the Audit Committee. The entire Board of Directors reviews the Company's financial performance and financial plan.

Susan E. Engel

Susan E. Engel
Chairwoman and Chief Executive Officer

INDEPENDENT AUDITORS' REPORT

TO THE BOARD OF DIRECTORS AND STOCKHOLDERS OF DEPARTMENT 56, INC.

We have audited the consolidated balance sheets of Department 56, Inc. and subsidiaries (the "Company") as of January 2, 1999 and January 3, 1998 and the related consolidated statements of income, cash flows and stockholders' equity for the years ended January 2, 1999, January 3, 1998, and December 28, 1996. 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 generally accepted auditing standards. 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, such consolidated financial statements present fairly, in all material respects, the financial position of the Company at January 2, 1999 and January 3, 1998 and the results of its operations and its cash flows for the years ended January 2, 1999, January 3, 1998, and December 28, 1996 in conformity with generally accepted accounting principles.

Deloitte & Touche LLP

Minneapolis, Minnesota
February 12, 1999, except for Note 4 thereto, as to which the date is March 19, 1999.

CORPORATE AND STOCKHOLDER INFORMATION

BOARD OF DIRECTORS

Susan E. Engel [1,5]
Chairwoman and Chief Executive Officer
Department 56, Inc.

Jay Chiat [3]
Investor/Consultant

Maxine Clark [2,3]
Founder and Chief Executive Officer
Build-A-Bear Workshop

Wm. Brian Little [1,3,5]
Private Investor

Gary S. Matthews [2]
President and Chief Executive Officer
Derby Cycle Corporation

Steven G. Rothmeier [1,2,4]
Chairman and Chief Executive Officer
Great Northern Capital

Vin Weber [3,4,5]
Partner
Clark & Weinstock Inc.

[1] *Member of Executive Committee*
[2] *Member of Audit Committee*
[3] *Member of Compensation Committee*
[4] *Member of Stock Incentive Committee*
[5] *Member of Nominating Committee*

OFFICERS

Susan E. Engel
Chairwoman and Chief Executive Officer

David W. Dewey
Executive Vice President – Overseas Operations

Brett D. Heffes
Vice President – Corporate Development

Mark R. Kennedy
Senior Vice President and Chief Financial Officer

Yeh-Huang Lin
Vice President – D56 Trading

Arete Passas
Executive Vice President – Marketing

Robert S. Rose
Vice President – Distribution and Operations

Timothy J. Schugel
Vice President – Finance and Sourcing Management

Joan M. Serena
Senior Vice President – Consumer and Dealer Marketing

Gregory G. Sorensen
Vice President – Management Information Systems

David H. Weiser
Senior Vice President – Legal/Human Resources and Secretary

Bruce R. Wollak
Vice President – D56 Sales

STOCKHOLDER INFORMATION

Corporate Offices
One Village Place
6436 City West Parkway
Eden Prairie, MN 55344

Transfer Agent
Chase Mellon
Shareholders Service
450 West 33rd Street
New York, NY 10001
www.chasemellon.com

Independent Auditors
Deloitte & Touche LLP

Stock Listing
New York Stock Exchange
Symbol "DFS"

Annual Meeting
1:30 p.m.
May 10, 1999
Mall of America
Playhouse Theater
Bloomington, MN

Department 56, Inc. Market Price (Per Share)

1998	High	Low
First Quarter	$39.00	$26.63
Second Quarter	$39.31	$32.19
Third Quarter	$36.75	$26.25
Fourth Quarter	$37.63	$22.94

1997	High	Low
First Quarter	$24.75	$16.88
Second Quarter	$23.00	$17.25
Third Quarter	$29.81	$21.00
Fourth Quarter	$31.75	$27.44

Copies of Department 56's annual report to the Securities and Exchange Commission on Form 10-K may be obtained without charge by contacting Investor Relations, Department 56, Inc., (612) 944-5600.

As of February 25, 1999, there were 913 record holders of the Company's common stock.

CONSUMER INFORMATION

The dealer nearest you can be identified by calling our consumer information line at 1-800-LIT-TOWN (1-800-548-8696) or by accessing our Web site at www.D56.com. Our Web site also includes other consumer information.

Department 56 INC.

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www.D56.com