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Yesterday's memories. Tomorrow's traditions

1 9 9 4 ANNUAL REPORT

Department 56 INC.

Letter from the Chairman

The Department 56 tradition of growth, innovation, and quality continued in fiscal 1994. Both areas of our business—Village Products and Other Giftware—grew substantially. As a result, we're pleased to report that the Company achieved another year of record sales and earnings.

FINANCIAL HIGHLIGHTS Department 56 earnings for the fiscal year ending December 31, 1994 increased 44 percent to $36.1 million or $1.67 per share, compared with $25.0 million or $1.16 per share, for fiscal 1993. Net sales rose 18 percent, reaching $217.9 million versus $184.4 million the prior year. Our collectible Village Products, including ceramic and porcelain lighted houses and accessories, accounted for 69 percent of total sales. Other Giftware, which includes the popular Snowbabies line, accounted for the remaining 31 percent of sales.

Our strong growth in operating profitability is primarily the result of an improved gross margin, reflecting increased efficiencies at our production facilities, favorable foreign currency exchange rates, and effective management of our overhead and fixed costs. Consistent with 1993, we prepaid an additional $40 million in subordinated debt at 1994 year-end from our strong cash flow.

NEW PRODUCTS Among our accomplishments in 1994, we introduced three outstanding new product lines: The Disney Parks Village Series; The Upstairs, Downstairs Bears;™ and Snowbunnies.™

The porcelain Disney Parks Village Series recreates the unique images of Disney theme parks. This is the seventh product line in The Heritage Village Collection. It also is our first new lighted Village series to be introduced since the North Pole© in 1991. The Disney Parks Village Series was introduced to consumers in September and is now available at select Department 56 dealers and Disney theme park stores.

Our second new line—The Upstairs, Downstairs Bears—features hand-painted resin bears attired in charming Edwardian costume, each on a mahogany base inlaid with a porcelain medallion identifying the name and title of the piece. Like other Department 56 products, The Upstairs, Downstairs Bears reflect a complete attention to detail not often found in reasonably priced giftware items—from the design and handcrafted intricacies, to the product's packaging.

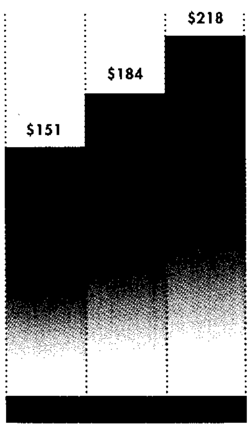
As an extension of our popular Snowbabies series, we introduced 10 Snowbunnies pieces during July in our Spring product line. In its first year on the market, demand was so strong that our entire production sold out in just five months. The Snowbunnies introduction serves as a prime example of what Department 56 does well—developing new market niches.

GROWTH STRATEGIES We believe that we have just begun to penetrate the market for our products. We intend to continue our proven growth strategy and build on the untapped market for our products by: strengthening Department 56 brand awareness and consumer loyalty; carefully developing the growth of our collectible product lines; continually producing new, innovative designs; sourcing high-quality products at affordable prices; and reaching consumers through our extensive distribution network of more than 19,000 quality giftware retailers.

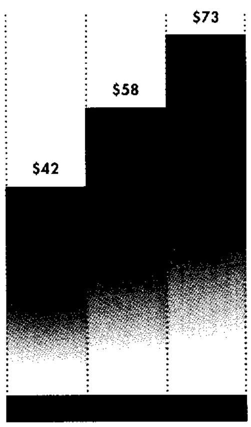
Financial Highlights

(Dollars in thousands, except per share amounts)	1994	1993	% Change
Net Sales	$217,865	$ 184,359	18%
Income From Operations	72,977	57,783	26%
Net Income	36,099	24,997	44%
Net Income Per Share	1.67	1.16	44%
Working Capital	$ 13,362	$ 26,392	
Total Assets	239,680	234,893	
Long-Term Debt	113,000	148,000	
Stockholders' Equity	100,305	61,731	

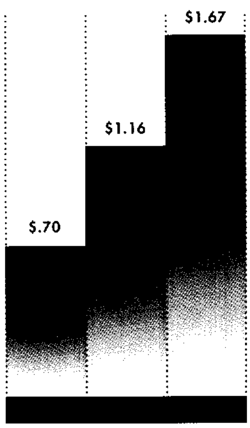
NET SALES
(Dollars in millions)



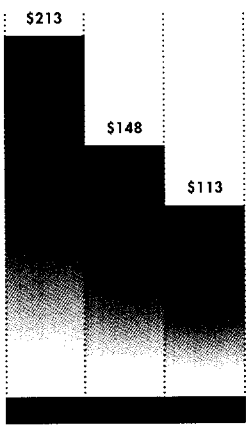
INCOME FROM OPERATIONS
(Dollars in millions)



NET INCOME PER SHARE



LONG-TERM DEBT
(Dollars in millions)



Department 56, Inc. is a leading designer, importer, and distributor of fine quality collectibles and other giftware products sold through gift, home accessory, and specialty retailers. The Company is best known for its collectible, handcrafted, lighted ceramic and porcelain houses, and related accessories in The Original Snow Village® and The Heritage Village Collection,® as well as for its extensive line of holiday and home decorative accessories, including its Snowbabies® collectible porcelain and pewter hand painted figurines.

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The majority of collectors buy two to three new Village pieces each year, providing an important consumer base from which to grow. In addition, our marketing efforts are focused on reaching first-time buyers who may become collectors. We expect to experience future growth through new collectors, introductions in existing Village series, and the creation of new Village Product lines. Among buyers of Village Products, the Department 56 brand name is six times more popular than our nearest competitor. We seek to build on that consumer loyalty.

The category of Other Giftware products will also play a key role in our future growth. Other Giftware creates opportunities to leverage our strengths in design and production. We often introduce new concepts in the Other Giftware category, like Snowbabies, that later develop into collectible product lines.

We continued to expand our worldwide production capabilities during fiscal 1994, using skilled artisans who meet our product standards. In particular, the expansion of our production in mainland China was a significant accomplishment that provides a strong competitive advantage. We have developed dependable, low-cost production sources there with proven abilities to produce extremely intricate pieces for Department 56. The volume of Department 56 products sourced from mainland China grew from 16 percent in 1993 to 29 percent in 1994. We anticipate that this trend will continue in fiscal 1995.

OUTLOOK Going forward, the contributions of the Company's management and employees are important to our future success. In 1994, we welcomed Susan Engel as our new president and chief operating officer. Susan brings 20 years of marketing and management experience to this position and we're delighted to have her as part of our team. She succeeds Todd Bachman, who left to become more active in the management of his family's business, but still remains on the Department 56 Board of Directors. We appreciate the many significant contributions Todd made at Department 56, and wish him well in his new endeavors.

We are pleased with our accomplishments to date, and we see many opportunities for future growth. Our guiding philosophy is the same today as it was in 1976, when we first introduced The Original Snow Village collection of lighted houses: to provide attractive, innovative products at affordable prices. And now, as a public company, our goal is also to create long-term value for our shareholders. We will continue to do both by offering consumers and collectors alike the handcrafted, quality giftware for which Department 56 is known.

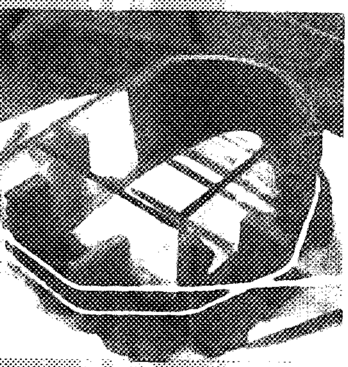
Edward R. Bazinet

Edward R. Bazinet

Chairman and Chief Executive Officer

DESIGN Production of every new Village building begins with the creation of scaled drawings. The roof, each side, and all exterior details are drawn in exact proportion to show the piece's architectural features.

SCULPTING A prototype model is sculpted from clay, capturing each individual detail of a building or an accessory. The model must be 15% larger than the desired product size to offset shrinkage during kiln firing.



MOLDS The clay models are used to create a "mothermold" from which production molds are cast. Because the detail of a mold erodes after 30 to 40 castings, hundreds of production molds are required for a single design.

Review of Operations

Department 56's growth is due in large part to our ability to produce high quality, handcrafted giftware at affordable prices. Our success in this area has enabled us to create pieces cost-effectively and with superb detail, giving Department 56 a significant competitive advantage over other giftware companies.

At Department 56 we strive to set new standards in every aspect of our design and production, continually seeking ways to combine materials and to add intricate finishing touches. Each piece — from The Original Snow Village to The Heritage Village Collection, to Snowbabies or one of our many Other Giftware lines — goes through a complex process on its way to becoming a finely handcrafted product.

First, every Department 56 product begins as an idea. It then goes through numerous stages of production on its way to the retailer's shelves. And although each stage is important to the creation of our product, it is the combination of all our processes — design, sculpting, hand painting, detailing, and packaging — that distinguishes Department 56's products from all others.

DESIGN We encourage our designers to challenge us with fresh product ideas; they often propose details that require new manufacturing techniques. For this reason, Department 56 has developed many industry "firsts," such as the "Village Animated Skating Pond" which was introduced in 1994. Skaters glide freely over a "frozen pond" without any visible connection to the motor in the base.

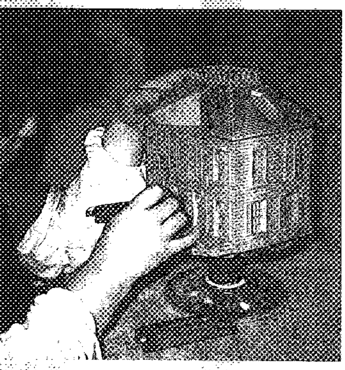
Our designers combine their own imagination with careful research of historic buildings and costumes to create the feeling of a particular

The Original Snow Village

I get such pleasure from my Original Snow Village. It reminds me of the small town I grew up in and just looking at my collection brings back so many fond memories. It takes me back to those magical white Christmases I loved as a child. What a long time ago that was! — Omaha

CASTING Liquid clay or "slip" is poured into production molds to form the pieces. The liquid clay remains in each mold for varying lengths of time depending on the size of the piece.

CASTING The excess liquid is poured out and the pieces continue to form as the mold draws moisture from the remaining clay. Once the pieces are set, the molds are opened and the pieces are carefully removed.



CUTTING WINDOWS After being removed from the mold, and before the clay hardens, window and door openings are hand cut on each of the houses. Every opening requires four to six separate hand cuts.

Village, down to the buckle on a shoe for an accessory piece or the type of shingles on a roof in the Dickens' Village. Department 56's master architects then produce scaled "blueprint" drawings of each design. On Village buildings, for example, all exterior details, such as windows, doors, porches, dormers, chimneys, and brick, must be drawn in precise proportion.

Full-size three-dimensional paper prototypes are then constructed from these "blueprint" drawings, which are used as detailed guides by experienced sculptors, who translate them into clay models.

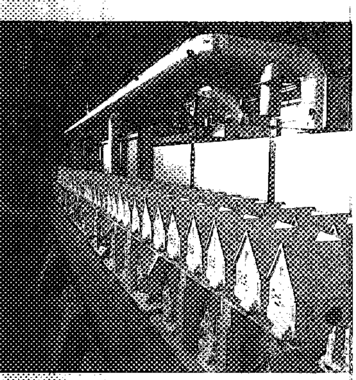
SCULPTING, MOLDING, AND CASTING The intricately sculpted clay models become the pattern from which the production molds are made. The sculpting and modeling process is therefore critical to bringing out the warmth and character of a Department 56 house or Village accessory design. It is at this stage the true details take shape. The depth and type of cut a sculptor makes on a roof's shingle or to an elf's facial features defines whether or not the final piece appears flat or comes alive. The production mold, in which the final piece is cast, is only as good as this clay model and is the key to manufacturing consistent product.

Department 56 sculptors are proficient at understanding the unique properties of clay. Clay is a difficult material to work with as it shrinks at various stages during the production process. Our sculptors must anticipate the 15 percent shrinkage during firing when sculpting the detail of any piece, such as the roundness in a face or the bricks of a building. For a lighted piece, the sculptors build a house wall by wall. They know how to contour each wall to compensate for the shrinkage during firing so that the detail remains in proportion and the building will be square. The sculptor's judgment and skill is applied

Dickens' Village™

Our whole family enjoys our Dickens' Village. My husband and I have been collecting for only three years, but we already have a beautiful display. It's become our annual Christmas tradition for our two young children to help us arrange it. They are as enchanted by it as we are. Each Christmas Eve, our family and friends gather around the tree and admire our glowing village from long ago — Seattle

ATTACHMENTS Attachments, such as Snowbabies wings, a church steeple, or a horse's legs, which have been separately cast, are now individually joined to the main body of the piece with liquid clay.



FIRING Pieces are stacked and loaded into large kilns that fire up to 450 pieces at one time, transforming clay into ceramic or porcelain. The firing process lasts approximately 15 hours at temperatures up to 1800° F.

HAND PAINTING Every Department 56 piece is a hand-crafted original. Our talented artists undergo extensive training that enables them to produce fine, hand-painted products.

to the various attachments that extend beyond the main body of the piece—to the chimney, porch, or dormers on a Village house.

The intricate sculpting process may take several weeks to complete. Once a piece is sculpted, a distinguishing stamp is added to the bottom of the piece, listing the title, year of original design, the appropriate series logo, and the Department 56 copyright symbol.

Using the original clay model, a series of production molds are then made from which final pieces are cast. After casting, pieces are removed from their molds and separately molded attachments are carefully "glued" into place with liquid clay. Also at this stage, windows and doors are skillfully hand cut. One individual design may have as many as 50 window openings, each requiring up to six separate hand cuts, totaling more than 300 cuts per piece. Casting marks and rough edges are brushed out and smoothed with liquid clay. Following inspection, pieces are fired at temperatures up to 1800° F, transforming the clay into rock-hard ceramic or porcelain.

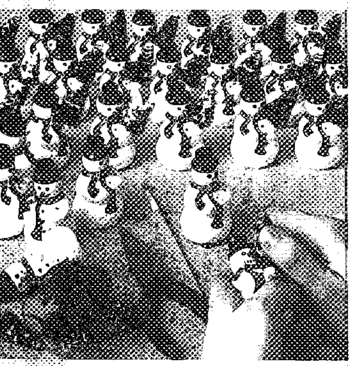
HAND PAINTING AND DETAILING Nowhere is the quality and style of Department 56 products more evident than in our hand painting and detailing. Hand painting, like sculpting, is critical to the appeal of each piece and brings to life a product's design. Every piece is individually hand-painted, requiring great patience and skill. Trained artisans expertly paint facial details, shutters around windows, or a welcome mat at the door. The painters work in teams. One team may work with the thinnest of brushes to shape the expressions on a caroler's face with each team member responsible for adding a different color or feature, while still another team adds snow to the roofs and doorways.

Special detailing techniques add touches that collectors expect from Department 56. The Dickens' Village accessory "Holiday Coach," for

Snowbabies

For Christmas last year my daughter gave me one of your Snowbabies, "Jack Frost...A Touch of Winter's Magic." I was hooked! And now I have several pieces in my collection. What I really like most about the Snowbabies is not only the beautiful quality, but your attention to detail. Each design is like a small story, complete with a title...you have captured my imagination. — ***Boston***

HAND PAINTING Hand painting is one of the most labor intensive stages of production. A variety of brush types are used to achieve the proper detail, facial features, and expressions.



DETAILING The addition of details such as sisal trees on a snowman, a touch of roping, reins, flags, or decals are the finishing touches that distinguish our product in the marketplace.

PACKAGING Department 56 products come in uniquely distinctive packages, preserving them for generations. Storybook boxing, illustrated sleeves, and individually molded storage cartons demonstrate our attention to detail.

example, has 19 separate attachments. Using a variety of materials, this horse-drawn carriage must be finished in multiple stages. The passengers and driver alone comprise eight separate porcelain pieces that are individually attached. Intricate crests are hand-applied to the doors of this coach, which rides on a separate metal undercarriage and wheels. Silver reins that drive four chestnut horses add to this piece's appeal.

The final touches on Snowbabies are what make them so unique. The porcelain bisque crystals are created by forcing pieces of clay through fine mesh screens, then sifting to achieve the proper uniform size. The figure is finally painted with liquid clay and showered with the porcelain bisque crystals. Other detailing touches may include a fishing pole, baton, or tiny porcelain stars tied with satin ribbons. Whatever the item, our attention to detail consistently differentiates Department 56 products in the marketplace.

PACKAGING Over the years, we have developed distinctive packaging that complements the handcrafted value of our products.

In our packaging, like our manufacturing, no detail is overlooked. Each Village piece is packed in its own custom-fit storage carton with an illustrated sleeve. This allows our collectibles to be preserved for generations to come. For Snowbabies and Snowbunnies, we've developed special storybook boxes which tell the tales of these charming collectibles. Our creative packaging and hang tags are used throughout our Christmas and Other Giftware lines and serve to further complement each piece's unique design.

Each year, new collectors discover what existing collectors already know — that Department 56 products are timeless pieces crafted with extraordinary skill and care. We take great pride in creating "Yesterday's Memories, Tomorrow's Traditions."

Tea Party

*I collect Dickens' Village and The North Pole and have always loved your quality and designs. I was shopping recently and came across a beautiful display of tins and ceramics called "Tea Party" only to discover it was made by Department 56. I was delighted and purchased several pieces. I had no idea you made so many different kinds of products. I know to keep an eye out for these now. —**Atlanta***

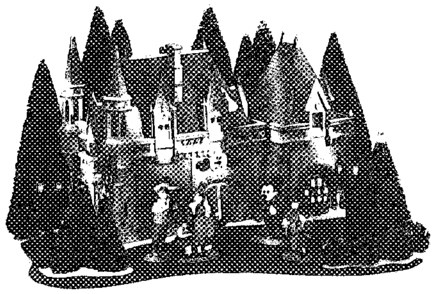
NORTH POLE SERIES

The North Pole Series was inspired by the enduring legend of Santa Claus. At the North Pole, Santa and his elves busily work and sing, preparing all sorts of toys for children everywhere.

- Year Introduced: 1990
- Total Lighted Pieces: 18
- Retired Pieces: 1
- Current Pieces: 17

DISNEY PARKS VILLAGE SERIES

Disney Parks Village Series pieces produced under authority of Walt Disney Co., Inc.



The wonderful world of Disney is interpreted with the new Disney Parks Village Series. These porcelain houses are the first recreations of existing Disney theme park buildings in Anaheim and Orlando. The collection includes Mickey's Christmas Shop, two antique shops, a fire station, and a Mickey and Minnie Mouse accessory, among others.

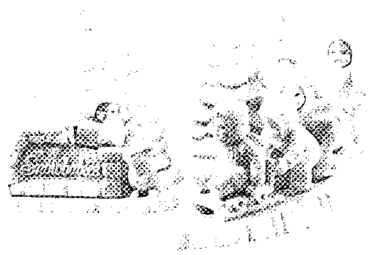
- Year Introduced: 1994
- Total Lighted Pieces: 5
- Retired Pieces: 0
- Current Pieces: 5

ALL AROUND THE PARK

In this 18-piece Village animated accessory set, figures take a mid-winter stroll on a cobblestone path surrounded by trees. The set can be incorporated into The Original Snow Village or any of the Heritage Village Series.

- Year Introduced: 1995

SNOWBABIES



Snowbabies have captivated the hearts of collectors everywhere. These bisque figurines convey an aura of innocence frozen forever in a moment of time. Snowbabies pieces also are available as ornaments, picture frames, music boxes, waterglobes, and in miniature pewter groupings.

- Year Introduced: 1986
- Total Bisque Figures: 80
- Retired Pieces: 35
- Current Pieces: 45

MERRY MAKERS

The collectible Merry Makers are a jovial group of porcelain monks, available as stand-alone figures, ornaments, and waterglobes. Each year, the Merry Makers collection depicts new "merry making" themes.

- Year Introduced: 1991
- Total Pieces: 53
- Retired Pieces: 0
- Current Pieces: 53

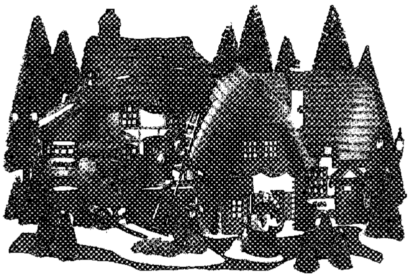
Department 56 at a Glance

THE ORIGINAL SNOW VILLAGE

The Original Snow Village recreates the warm, nostalgic images of a snow-covered "Main Street U.S.A." cheerfully lighted and decorated for the holidays. This became the first series of lighted Villages to be produced by Department 56.

- Year Introduced: 1976
- Total Lighted Pieces: 178
- Retired Pieces: 143
- Current Pieces: 35

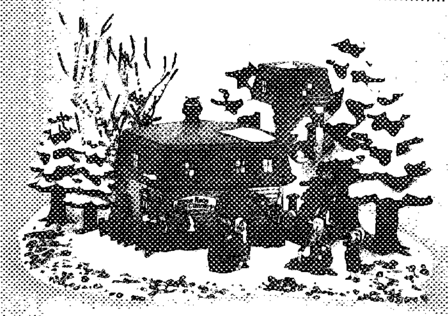
DICKENS' VILLAGE SERIES



Charles Dickens' classic tale, *A Christmas Carol*, captured the spirit of Christmas in Victorian England. The Department 56 Dickens' Village Series recreates this bygone era with an assortment of period shops and accessories, including characters from Dickens' stories.

- Year Introduced: 1984
- Total Lighted Pieces: 78
- Retired Pieces: 51
- Current Pieces: 27

NEW ENGLAND VILLAGE SERIES



The New England Village Series depicts winter scenes in an early American era of covered bridges, log cabins, and horse-drawn sleighs. This collection reminds one of the song verse, "Dashing through the snow, in a one-horse open sleigh..."

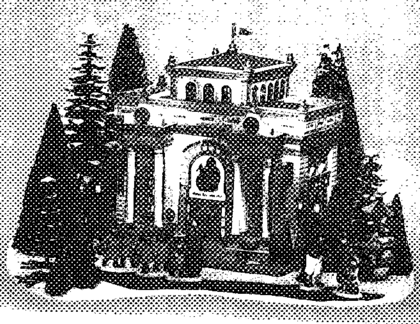
- Year Introduced: 1986
- Total Lighted Pieces: 37
- Retired Pieces: 25
- Current Pieces: 12

ALPINE VILLAGE SERIES

The Alpine Village Series recreates the old-world charm of hamlets in the Austrian and Swiss Alps. Buildings such as a farmhouse, grist mill, and church with a clock tower lend a quaint air to this mountain Village.

- Year Introduced: 1986
- Total Lighted Pieces: 14
- Retired Pieces: 3
- Current Pieces: 11

CHRISTMAS IN THE CITY SERIES



Bustling crowds and cheerfully lighted shops create a joyous mood for the Christmas in the City Series. Activities abound as throngs of people mingle, buying gifts, lighting the Town Tree, attending the theater, and worshipping at the cathedral.

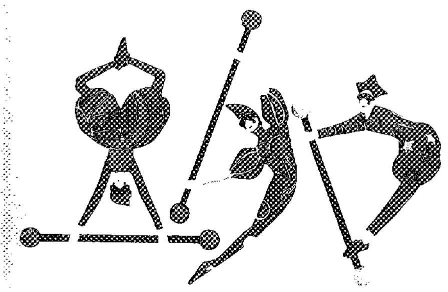
- Year Introduced: 1987
- Total Lighted Pieces: 31
- Retired Pieces: 18
- Current Pieces: 13

Product Overview

The Department 56 name has become highly regarded among consumers and retailers, since the Company was founded in 1976. Each year, Department 56 introduces new hand-crafted pieces. In 1994, the Company offered more than 2,000 different products, of which 600 were new. These products were sold through more than 19,000 retailers nationwide. We maintain an overall constant number of products — such as our collectible lighted Village pieces, accessories, and Snowbabies — by retiring selected pieces on an annual basis. For a glimpse of the wide variety of Department 56 offerings, turn to the following pages.

- The Original Snow Village
- Dickens' Village
- New England Village
- Alpine Village
- Christmas In The City
- North Pole
- Disney Parks Village
- All Around The Park
- Snowbabies
- Merry Makers
- Winter Silhouette
- ...All Through The House
- Mercury Glass
- Jingle
- Father Frost
- Cirque Du Soleil
- Tea Party
- Silver Collection
- Upstairs, Downstairs Bears
- Snowbunnies

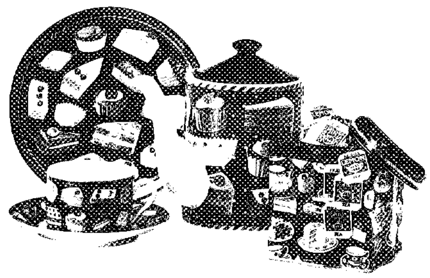
CIRQUE DU SOLEIL *Licensed by Determined Productions, Inc.*



Translating the bold, sophisticated style of the Cirque Du Soleil, Department 56 created a brilliantly colored trim line of ornaments and tins. Uniquely non-traditional, our Cirque Du Soleil line captures the dramatic flair of this famous acrobatic troupe.

- Year Introduced: 1995

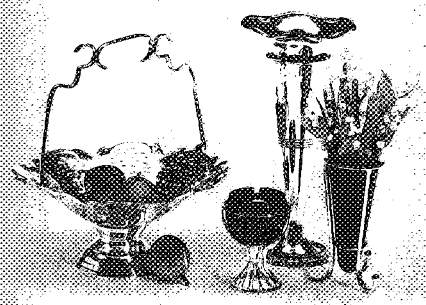
TEA PARTY



The Tea Party line brings a fresh, new look to afternoon tea. The striking polka-dot motif appears on oversize teapots, cups, saucers, plates, and tins.

- Year Introduced: 1995

SILVER COLLECTION



The Silver collection by Department 56 represents the Company's ability to offer the market a combination of design, style, and value. These non-seasonal home accessories include items such as candle holders, vases, trays, and wire baskets.

- Year Introduced: 1995

UPSTAIRS, DOWNSTAIRS BEARS

The hand painted, cold cast resin Upstairs, Downstairs Bears feature a family, their friends, and household staff attired in traditional Edwardian costume, with mahogany bases. They are adapted from the original designs by Carol Lawson, a well-known English illustrator and author.

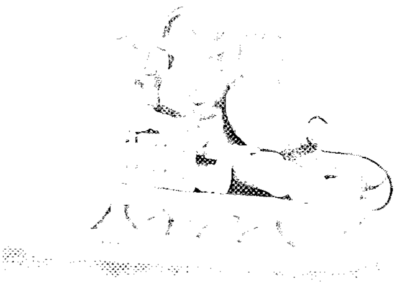
- Year Introduced: 1994
- Total Pieces: 25

SNOWBUNNIES

The Snowbunnies collection is an extension of our collectible Snowbabies series. The playful and heartwarming Snowbunnies add a new dimension to Department 56's spring product line.

- Year Introduced: 1994
- Total Pieces: 10

WINTER SILHOUETTE



The pristine white of new fallen snow is captured in each classically designed Winter Silhouette piece. These collectible, winter-white porcelain scenes reflect the serene beauty of the season.

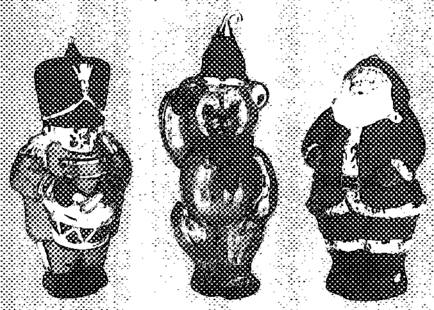
- Year Introduced: 1987
- Total Pieces: 57
- Retired Pieces: 11
- Current Pieces: 46

...ALL THROUGH THE HOUSE

The Department 56 collection...All Through The House interprets the spirit of the classical Clement C. Moore poem, *A Visit From St. Nicholas*. Facades of houses—detailed inside and out—and homey scenes, depicting the preparation for the holiday, bring this story of the night before Christmas to life.

- Year Introduced: 1991
- Total Pieces: 44
- Retired Pieces: 0
- Current Pieces: 44

MERCURY GLASS



Our Mercury Glass collection is reminiscent of old, vintage European ornaments. Department 56 has developed a unique line of oversize Christmas decorations which come in traditional and contemporary styles—from bright, solid-colored globes and finials, to tree ornaments featuring, for example, a Santa Claus, a teddy bear, an ice cream cone, a candy cane, and a buffalo nickel.

- Year Introduced: 1988
- Total Pieces: 238 of which 44 are dimensional

JINGLE

The Jingle line demonstrates Department 56's ability to coordinate a single graphic theme across a wide variety of giftware items. Jingle products depict a glitzy red, gold, and black musical motif on a variety of hanging ornaments, accessories, and tabletop—including glasses, tins, trays, and wreaths.

- Year Introduced: 1995

FATHER FROST

The Father Frost trim line features papier-mache figures and ornaments that capture the nostalgic image of old European designs.

- Year Introduced: 1993
- Total Pieces: 26

Financial Review

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Five Year Summary

(In thousands, except per share amounts)	Company: Year Ended Dec. 31, 1994[1]	Year Ended Jan. 1, 1994[1]	Year Ended Jan. 2, 1993[1,2] (Pro forma for the Acquisition)	Oct. 4, 1992 – Jan. 2, 1993	Predecessor Company: Dec. 29, 1991 – Oct. 3, 1992	Year Ended Dec. 28, 1991[1]	47 Wks. Ended Dec. 29, 1990[1]
STATEMENTS OF OPERATIONS							
Net sales	$217,865	$184,359	$150,754	$ 24,600	$125,713	$121,712	$92,441
Cost of sales	98,480	87,331	74,958	12,967	62,485	60,848	49,061
Gross profit	119,385	97,028	75,796	11,633	63,228	60,864	43,380
Operating expenses:							
Selling, general and administrative	41,831	34,670	29,151	7,537	20,678	23,187	16,001
Performance bonuses[3]	–	–	450	–	6,658	5,654	3,935
Amortization of goodwill and trademarks	4,577	4,575	4,568	1,150	–	–	–
Nonrecurring charges[4]	–	–	–	–	28,350	–	–
Total operating expenses	46,408	39,245	34,169	8,687	55,686	28,841	19,936
Income from operations	72,977	57,783	41,627	2,946	7,542	32,023	23,444
Other expense (income):							
Interest expense	12,629	16,143	16,339	4,341	790	1,134	1,123
Other, net	(837)	(1,030)	(1,044)	(304)	(503)	(777)	(487)
Income (loss) before income taxes	61,185	42,670	26,332	(1,091)	7,255	31,666	22,808
Provision (benefit) for income taxes	25,086	17,673	11,168	(24)	6,887	11,552	7,998
Net income (loss)	$ 36,099	$ 24,997	$ 15,164	$ (1,067)	$ 368	$ 20,114	$14,810
Net income (loss) per share	$ 1.67	$ 1.16	$ 0.70	$ (0.05)			

	Dec. 31, 1994	Jan. 1, 1994	Jan. 2, 1993	Dec. 28, 1991	Dec. 29, 1990
BALANCE SHEET DATA					
Cash and cash equivalents	$ 2,180	$ 7,366	$ 38,355	$ 13,072	$ 8,535
Marketable securities	–	–	9,870	5,881	4,625
Working capital	13,362	26,392	61,697	34,138	28,246
Total assets	239,680	234,893	275,370	61,751	48,833
Long-term debt, including current maturities	113,000	148,000	213,000	5,051	5,670
Total stockholders' equity[5]	100,305	61,731	37,158	41,382	31,849

1 The years ended December 28, 1991, January 1, 1994 and December 31, 1994 were 52-week periods and the year ended January 2, 1993 was a 53-week period. In 1990, the Predecessor Company changed its fiscal year end for financial reporting purposes from the Saturday closest to January 31 to the Saturday closest to December 31. Therefore, the period ended December 29, 1990 includes only 47 weeks.

2 The pro forma statement of operations for the year ended January 2, 1993 is based on the assumption that the Acquisition had occurred on December 29, 1991. The pro forma data includes the effects of adjustments to historical asset values as required by the purchase accounting method, adjustments to interest expense to reflect financing costs of the Acquisition, amortization of intangibles related to the Acquisition, adjustments to eliminate performance bonus payments related to Predecessor Company employment contracts that were terminated in connection with the Acquisition, adjustments for nonrecurring costs incurred by the Predecessor Company and the related income tax effect of the preceding items (see Note 1 to the Consolidated Financial Statements).

3 Reflects performance bonuses that the Predecessor Company paid in connection with employment agreements it had with certain officers, which agreements were terminated in connection with the Acquisition (see Note 7 to the Consolidated Financial Statements).

4 Nonrecurring charges include payments to terminate employment contracts, special bonuses and costs incurred by the Predecessor Company in connection with the Acquisition (see Note 10 to the Consolidated Financial Statements).

5 Since the Acquisition, 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. The revolving credit agreement of D 56, Inc. (the principal operating subsidiary of the Company) permits it to declare and pay cash dividends (subject to certain limitations) to the Company which may then be declared and paid to holders of Common Stock.

Management's Discussion and Analysis

RESULTS OF OPERATIONS

The Company was organized in 1992 by affiliates of Forstmann Little & Co. (the "Forstmann Little Partnerships") for the purpose of acquiring D 56, Inc. (the "Predecessor Company"), referred to herein as the "Acquisition" (See Note 1 to the Consolidated Financial Statements). The Company operates primarily in the collectible area of the giftware industry.

For purposes of discussion set forth below, the results of operations for 1992 are shown pro forma for the Acquisition and based on the assumption that the Acquisition had occurred on December 29, 1991. The pro forma results of operations for 1992 reflect the effects of adjustments to historical asset values as required by the purchase accounting method, adjustments to interest expense to reflect the financing costs of the Acquisition, amortization of intangible assets related to the Acquisition, adjustments to eliminate performance bonus payments related to the Predecessor Company's employment contracts that were terminated in conjunction with the Acquisition, adjustments for nonrecurring costs incurred by the Predecessor Company and the related income tax effects of the preceding items.

COMPARISON OF RESULTS OF OPERATIONS

1994 TO 1993

Net Sales. Net sales increased $33.5 million, or 18%, from $184.4 million in 1993 to $217.9 million in 1994. This increase was due principally to an increase in volume. Sales of Village Series products increased 22% from 1993 to 1994, while Other Giftware product sales increased 11% during the same period. Village Series products continued to account for the most significant portion of the Company's sales, 69% in 1994 versus 67% in 1993.

The increase in the sales volume of Village Series products during 1994 resulted from continued strong customer demand which was supported by the introduction of new lighted pieces. Demand for the Village Series products continued to exceed supply in 1994. As a result, the Company continued its policy of allocating the amount of Village Series products customers were allowed to purchase in both 1993 and 1994, as well as limiting the number of new accounts that carry Village Series products. This allocation policy, begun in 1989, has enabled the Company to control growth and enhance the collectibility of its Village Series products.

	1994		1993		1992 (Pro Forma for the Acquisition)	
(In millions, except per share amounts)	Dollars	Percent of Net Sales	Dollars	Percent of Net Sales	Dollars	Percent of Net Sales
Net sales	$217.9	100%	$184.4	100%	$150.8	100%
Gross profit	119.4	55	97.0	53	75.8	50
Selling, general and administrative expenses	41.8	19	34.7	19	29.6	20
Amortization of goodwill and trademarks	4.6	2	4.6	2	4.6	3
Income from operations	73.0	33	57.8	31	41.6	28
Interest expense	12.6	6	16.1	9	16.3	11
Other, net	(.8)	–	(1.0)	(1)	(1.0)	(1)
Income before income taxes	61.2	28	42.7	23	26.3	17
Provision for income taxes	25.1	12	17.7	10	11.1	7
Net income	36.1	17	25.0	14	15.2	10
Net income per share	1.67		1.16		0.70	

In Other Giftware products, sales increased at a lower rate than the Company's overall sales. The Company has continued its policy, begun in 1992, of allocating the supply of its Snowbabies products to customers and limiting the number of new accounts that carry Snowbabies products.

Gross Profit. Gross profit increased $22.4 million, or 23%, between 1993 and 1994. Gross profit as a percentage of sales increased from approximately 53% in 1993 to approximately 55% in 1994, principally as a result of decreased product costs due to lower cost, high quality production capacity added during 1994, as well as favorable foreign currency exchange rates and $30 million of non-deliverable New Taiwan dollar contracts.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased $7.2 million, or 21%, between 1993 and 1994, and remained relatively constant at 19% of sales in both periods. The increase in expenses was primarily due to higher sales and marketing expenses, including commissions, on the Company's higher sales volume. These expenses generally vary in proportion to the Company's sales.

Income from Operations. Income from operations increased $15.2 million, or 26%, from 1993 to 1994 due to the factors described above. Operating margins increased from 31% of net sales in 1993 to 33% of net sales in 1994.

Interest Expense. Interest expense decreased $3.5 million, or 22%, between 1993 and 1994 due to the prepayment of $65 million of subordinated debentures on December 31, 1993.

Provision for Income Taxes. The effective income tax rate remained relatively constant at 41% during both 1993 and 1994.

COMPARISON OF RESULTS OF OPERATIONS
1993 TO PRO FORMA 1992

Net Sales. Net sales increased $33.6 million, or 22%, from $150.8 million in 1992 to $184.4 million in 1993. This increase was due principally to higher sales volume in all major product categories. Sales of Village Series products increased 16% from 1992 to 1993, while Other Giftware products sales increased 32% during the same period. While Village Series products continued to account for the most significant portion of net sales, Village Series decreased from 70% of net sales in 1992 to 67% of net sales in 1993. The proportion of net sales derived from Village Series products decreased in 1993 due to the continued rapid sales growth of the Company's Other Giftware products. Demand for Village Series continued to exceed supply in 1993. As a result, the Company continued its policy of allocating the amount of Village Series products customers were allowed to purchase in both 1993 and 1992, as well as limiting the number of new accounts that carry Village Series products. Allocation of the Village Series, begun in 1989, has enabled the Company to control growth and enhance the collectibility of its Village Series products.

The sales volume increase in the Village Series products in 1993 resulted from continued strong customer demand which was supported by the introduction of new lighted pieces.

In Other Giftware products, sales of the Company's General Christmas product lines during 1993 increased at a greater rate than the Company's overall sales. In addition, sales of the Snowbabies product line continued to expand at a higher rate than the Company's overall sales. Demand for Snowbabies products continued to exceed supply in 1993 and the Company continued its policy, begun in 1992, of allocating supply to customers and limiting the number of new accounts that carry Snowbabies products.

Gross Profit. Gross profit increased $21.2 million, or 28%, between 1992 and 1993. Gross profit as a percentage of net sales increased from approximately 50% in 1992 to approximately 53% in 1993, principally as a result of decreased inventory costs due to the relative decline in the New Taiwan dollar, and also due to lower cost, high quality production capacity that was added in 1993.

Selling, General and Administrative Expenses. Selling, general and administrative expenses increased $5.1 million, or 17%, between 1992 and 1993, and declined slightly from 20% of net sales in 1992 to 19% in 1993. The increase in expenses was primarily due to higher sales and marketing expenses, including commissions, on the Company's higher sales volume. These expenses generally vary in proportion to the Company's sales.

Income from Operations. Income from operations increased $16.2 million, or 39%, from 1992 to 1993 due to the factors described above. Operating margins increased from 28% of net sales in 1992 to 31% of net sales in 1993.

Interest Expense. Interest expense remained relatively constant, decreasing $0.2 million, or 1%, between 1992 to 1993.

Provision for Income Taxes. The effective income tax rate decreased from 42% in 1992 to 41% in 1993. The effect of the 1 percentage point increase in the Federal income tax rate in 1993 was more than offset by the effect of the decrease of the nondeductible goodwill amortization expense as a percentage of income before income taxes.

SEASONALITY

	1994					1993				
(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]	$181.0	$27.0	$20.2	$8.9	$237.1	$157.5	$21.8	$13.2	$5.2	$197.7
Net sales	45.5	64.4	66.4	41.6	217.9	39.2	55.4	57.0	32.8	184.4
Gross profit	24.6	35.4	36.4	23.0	119.4	20.0	28.9	30.4	17.7	97.0
Selling, general and administrative expenses	8.8	10.8	10.5	11.7	41.8	7.5	9.4	9.0	8.8	34.7
Amortization of goodwill and trademarks	1.1	1.1	1.2	1.2	4.6	1.1	1.1	1.2	1.2	4.6
Income from operations	14.7	23.5	24.7	10.1	73.0	11.4	18.4	20.2	7.8	57.8
Net income	7.1	12.0	12.8	4.2	36.1	4.6	8.8	9.3	2.3	25.0
Net income per share	0.33	0.56	0.59	0.19	1.67	0.21	0.41	0.43	0.11	1.16

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

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 76% and 80% of its total annual customer orders for 1994 and 1993, respectively, during the first quarter of each of those years. Cancellations were approximately 5% of total annual customer orders in each of 1994 and 1993. The Company's backlog was $8.4 million and $5.3 million at December 31, 1994 and January 1, 1994, respectively.

The Company shipped and recorded as net sales approximately 92% and 93% of its annual customer orders in 1994 and 1993, 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 Easter orders.

The Company receives products, pays its suppliers and ships products throughout the year, although 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 annual growth objectives which are consistent with the Company's business strategy.

LIQUIDITY AND CAPITAL RESOURCES

In February 1995, the Company entered into a new credit agreement providing a $100 million term loan and a revolving line of credit. In connection therewith, the Company will record an extraordinary charge of $1,312,000, net of tax, to write off deferred financing costs during the first quarter of 1995. The Company used the proceeds of the term loan combined with $8 million of the revolving line of credit to refinance its subordinated debt. The term loan is due and payable in five consecutive installments of $20 million, payable on December 31 of each year, commencing December 31, 1995. The Company believes that its internally generated cash flow and seasonal borrowings under the revolving line of credit will be more than adequate to fund operations, capital expenditures, and required principal payments on its term loan for the next 12 months.

The revolving line of credit provides for borrowings of up to $90 million including letters of credit. The letters of credit are issued primarily in connection with inventory purchases. The credit agreement contains numerous financial and operating covenants, including restrictions on incurring indebtedness and liens, entering into any transaction to acquire or merge with any entity or making certain other fundamental changes, selling property, incurring capital expenditures and paying dividends. In addition, D 56, Inc. is required to satisfy consolidated net worth, interest coverage ratio and current ratio tests, in each case at the end of each fiscal quarter.

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 and marketable securities balances, internally generated cash flow and seasonal borrowings. The Company's bad debt experience relating to these accounts receivable has not been material.

The Company's net cash and marketable securities balances peak in December, following the collection in November and December of accounts receivable with extended payment terms. On December 30, 1994 and December 31, 1993, the Company prepaid subordinated debentures with an aggregate principal amount of $40 million and $65 million, respectively. At December 31, 1994, cash and cash equivalents balances were $2.2 million as compared to $7.4 million at January 1, 1994.

Accounts receivable increased from $13.6 million at January 1, 1994 to $24.0 million at December 31, 1994 principally as a result of increased volume, later shipments in 1994 than 1993, a larger amount of receivables qualifying for December dating terms and slightly slower payment patterns in 1994 versus 1993.

Capital expenditures were $2.6 million, $1.3 million and $1.0 million for 1994, 1993 and 1992, respectively.

On June 17, 1993, the Forstmann Little Partnerships and certain members of senior management and other employees of the Company completed an initial public offering of 5.29 million shares of common stock at a price of $18.00 per share and received net cash proceeds from the offering of approximately $88.7 million. On May 5, 1994, the Forstmann Little Partnerships and certain members of senior management and other employees of the Company completed a public offering of 5.75 million shares of common stock at a price of $27⅜ per share and received net cash proceeds from the offering of approximately $150.3 million.

FOREIGN EXCHANGE

The dollar value of the Company's assets abroad is not significant. 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 Taiwan (Republic of China), China and The Philippines. The Company's costs could be adversely affected on a short-term basis if the New Taiwan dollar (or the currencies of other countries in which the Company conducts business) appreciates significantly relative to the U.S. dollar. 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.

At December 31, 1994, the Company had $32.5 million of foreign exchange contracts outstanding to hedge 1995 Taiwan dollar denominated inventory purchases. These contracts mature from January 1995 through December 1995 at a rate of 27.00 NT$/US$.

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 judgements.

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 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.

Edward R. Bazinet
Chief Executive Officer

Consolidated Balance Sheets

(In thousands, except per share amounts)	Company December 31, 1994	Company January 1, 1994
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 2,180	$ 7,366
Accounts receivable, net of allowances of $5,232 and $4,784, respectively	23,959	13,555
Inventories	20,366	17,395
Deferred taxes	3,161	2,986
Other current assets	2,723	3,282
Total current assets	52,389	44,584
Property and equipment, net	12,330	10,908
Goodwill, net of accumulated amortization of $9,295 and $5,166, respectively	155,878	160,007
Trademarks, net of accumulated amortization of $1,007 and $559, respectively	16,893	17,341
Other assets	2,190	2,053
	$239,680	$234,893
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Current portion of long-term debt	$ 20,000	$ –
Accounts payable	5,157	5,146
Commissions payable	4,209	3,619
Accrued interest	646	870
Other current liabilities	9,015	8,557
Total current liabilities	39,027	18,192
Deferred taxes	7,348	6,970
Long-term debt	93,000	148,000
Commitments (note 8)		
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 21,475 and 21,343 shares, respectively	215	213
Additional paid-in capital	40,244	38,269
Unearned compensation on common stock options	(183)	(681)
Retained earnings	60,029	23,930
Total stockholders' equity	100,305	61,731
	$239,680	$234,893

See notes to consolidated financial statements.

Consolidated Statements of Operations

(In thousands, except per share amounts)	Company: Year ended December 31, 1994	Company: Year ended January 1, 1994	Company: October 4, 1992 through January 2, 1993	Predecessor Company: December 29, 1991 through October 3, 1992
Net sales	$217,865	$184,359	$24,600	$125,713
Cost of sales	98,480	87,331	12,967	62,485
Gross profit	119,385	97,028	11,633	63,228
Operating expenses:				
Selling, general and administrative	41,831	34,670	7,537	20,678
Performance bonuses	–	–	–	6,658
Amortization of goodwill and trademarks	4,577	4,575	1,150	–
Nonrecurring charges	–	–	–	28,350
Total operating expenses	46,408	39,245	8,687	55,686
Income from operations	72,977	57,783	2,946	7,542
Other expense (income):				
Interest expense	12,629	16,143	4,341	790
Other, net	(837)	(1,030)	(304)	(503)
Income (loss) before income taxes	61,185	42,670	(1,091)	7,255
Provision (benefit) for income taxes	25,086	17,673	(24)	6,887
Net income (loss)	$ 36,099	$ 24,997	$ (1,067)	$ 368
Net income (loss) per share	$ 1.67	$ 1.16	$ (0.05)	
Weighted average common and common equivalent shares outstanding	21,649	21,544	21,548	

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

(In thousands)	Company Year ended December 31, 1994	Company Year ended January 1, 1994	Company October 4, 1992 through January 2, 1993	Predecessor Company December 29, 1991 through October 3, 1992
Cash Flows from Operating Activities:				
Net income (loss)	$ 36,099	$ 24,997	$ (1,067)	$ 368
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:				
Depreciation	1,296	1,037	280	801
Amortization of goodwill, trademarks and other intangible assets	5,254	5,243	1,266	–
Provision for uncollectible accounts receivable	1,107	1,922	455	1,528
Compensation expense—common stock options	498	829	–	–
Imputed interest	–	–	727	–
Deferred taxes	203	(682)	(462)	(1,111)
Nonrecurring charges	–	–	–	28,350
Changes in assets and liabilities:				
Accounts receivable	(11,511)	(3,590)	55,949	(53,985)
Prepayment to Fifty-Six Trading Co., Ltd. for inventory	–	–	–	(5,826)
Inventories	(2,971)	(719)	(4,924)	3,216
Other assets	(361)	(2,299)	170	(535)
Accounts payable	11	(1,331)	2,766	3,033
Commissions payable	590	1,369	(3,037)	3,189
Accrued interest	(224)	(2,284)	3,117	21
Other current liabilities	1,403	698	(33,293)	(4,574)
Net cash provided by (used in) operating activities	31,394	25,190	21,947	(25,525)
Cash Flows from Investing Activities:				
Acquisition, net of cash acquired	–	–	(233,460)	–
Sales of marketable securities	–	9,870	–	15,464
Purchases of marketable securities	–	–	(9,409)	(10,044)
Proceeds from the disposal of property and equipment	–	–	–	445
Purchases of property and equipment	(2,621)	(1,296)	(158)	(866)
Net cash provided by (used in) investing activities	(2,621)	8,574	(243,027)	4,999
Cash Flows from Financing Activities:				
Proceeds from the exercise of common stock options	1,041	247	–	–
Borrowings on revolving credit agreement	97,577	–	–	21,500
Principal payments on revolving credit agreement	(92,577)	–	(18,583)	(3,000)
Principal payments on long-term debt	(40,000)	(65,000)	(6,007)	(980)
Proceeds from the issuance of subordinated debentures	–	–	213,000	–
Proceeds from the issuance of common stock	–	–	71,025	–
Dividends paid	–	–	–	(244)
Net cash provided by (used in) financing activities	(33,959)	(64,753)	259,435	17,276
Net increase (decrease) in cash and cash equivalents	(5,186)	(30,989)	38,355	(3,250)
Cash and cash equivalents at beginning of period	7,366	38,355	–	13,072
Cash and cash equivalents at end of period	$ 2,180	$ 7,366	$ 38,355	$ 9,822

See notes to consolidated financial statements.

Consolidated Statements of Stockholders' Equity

(In thousands)	Common Stock Shares	Common Stock Amount	Retained Earnings	Total Stockholders' Equity
PREDECESSOR COMPANY				
Balance as of December 28, 1991	500	$250	$41,132	$41,382
Dividends	–	–	(162)	(162)
Net income	–	–	368	368
Balance as of October 3, 1992	500	$250	$41,338	$41,588

(In thousands)	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Unearned Compensation on Common Stock Options	Retained Earnings (Deficit)	Total Stockholders' Equity
COMPANY						
Initial capitalization as of October 4, 1992	21,308	$213	$ 68,612	$ –	$ –	$ 68,825
Reduction for predecessor cost carryover basis	–	–	(30,600)	–	–	(30,600)
Net loss	–	–	–	–	(1,067)	(1,067)
Balance as of January 2, 1993	21,308	213	38,012	–	(1,067)	37,158
Net income	–	–	–	–	24,997	24,997
Shares issued upon the exercise of common stock options	35	–	247	–	–	247
Common stock options granted	–	–	1,510	(1,510)	–	–
Common stock options vested	–	–	–	829	–	829
Accrued stock issuance costs	–	–	(1,500)	–	–	(1,500)
Balance as of January 1, 1994	21,343	213	38,269	(681)	23,930	61,731
Net income	–	–	–	–	36,099	36,099
Shares issued upon the exercise of common stock options	132	2	1,975	–	–	1,977
Common stock options vested	–	–	–	498	–	498
Balance as of December 31, 1994	21,475	$215	$ 40,244	$ (183)	$60,029	$100,305

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

(In thousands, except share and per share amounts)

1. ACQUISITION

In October 1992, Department 56, Inc. (the "Company"), through its wholly owned subsidiary, FL 56 Intermediate Corp. ("Intermediate"), corporations formed by affiliates of Forstmann Little & Co. ("FL & Co."), entered into a purchase agreement to acquire all of the outstanding common stock of Bachman's Holdings, Inc. ("BHI") and ed bazinet international, inc., the sole stockholders of D 56, Inc., and the assets, subject to certain liabilities, of Fifty-Six Trading Co., Ltd. (referred to herein as the Acquisition) for an aggregate purchase price of $250,263, including $7,097 of acquisition costs. The purchase price, and the payment of nonrecurring charges (see Note 10) and certain assumed debt obligations were funded by the issuance of $71,025 of common stock, before the accrual of $2,200 for stock offering expenses, and $213,000 of subordinated debentures. The Acquisition was consummated on October 15, 1992, and BHI was subsequently dissolved and its assets were transferred to Intermediate. The Acquisition was recorded as of October 4, 1992 and, consequently, the statement of operations for the period from October 4, 1992 to January 2, 1993 includes a $727 charge for imputed interest on the purchase price from that date to October 15, 1992. D 56, Inc. is referred to as the Predecessor Company on or prior to the date of the Acquisition.

The Acquisition has been reflected in the accompanying consolidated financial statements using the purchase method of accounting. Accordingly, the assets acquired and the liabilities assumed in connection with the Acquisition have been recorded at their fair values. The fair values of assets and liabilities were based on independent appraisals and estimates by management. The allocation of the purchase price was as follows:

Current assets	$101,845
Property and equipment	10,862
Intangibles and other assets	216,262
Liabilities assumed	(78,706)
	$250,263

In connection with the Acquisition, the Company has recorded a reduction for predecessor cost carryover basis. The adjustment reduced the predecessor stockholders' investments in the Company to the original cost of the predecessor stockholders' investments in the Predecessor Company plus their proportionate shares of net earnings and distributions.

The following unaudited pro forma results of operations are based on the assumption the Acquisition had occurred on December 29, 1991 and that the purchase price would have been the same. The pro forma results reflect the effects of adjustments to historical asset values as required by the purchase accounting method, adjustments to interest expense to reflect the financing costs of the Acquisition, amortization of intangible assets related to the Acquisition, adjustments to eliminate performance bonus payments related to the Predecessor Company's employment contracts that were terminated in conjunction with the Acquisition, adjustments for nonrecurring costs incurred by the Predecessor Company and the related income tax effects of the preceding items.

Year ended	Jan. 2, 1993
Net sales	$150,754
Net income	$ 15,164
Net income per common share	$ 0.70

The pro forma results have been prepared for comparative purposes only and do not purport to represent what the results would have been if the Acquisition had actually occurred on December 29, 1991 or to project the future results.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business — The Company is engaged in the original design, importation, and wholesale distribution of specialty giftware products. 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.

Principles of Consolidation — The accompanying consolidated financial statements of the Company include the accounts of the Company and its subsidiaries, FL 56 Intermediate Corp., ed bazinet international, inc., D 56, Inc.,

Notes to Consolidated Financial Statements

(In thousands, except share and per share amounts)

Browndale Tanley Limited and Department 56 Trading Co., Ltd., all of which are wholly owned. The accompanying consolidated financial statements of the Predecessor Company include the accounts of the Predecessor Company and its wholly owned subsidiary, Browndale Tanley Limited. All significant intercompany accounts and transactions have been eliminated in consolidation.

Fiscal Year End — The Company's policy is to end its fiscal year on the Saturday closest to December 31. The period ended January 2, 1993 includes 13 weeks, the period ended October 3, 1992 includes 40 weeks and the years ended January 1, 1994 and December 31, 1994 include 52 weeks.

Cash and Cash Equivalents — 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 sheet.

Inventories — 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 Taiwan and other Pacific Rim countries. Each period the Company provides for identified, unsalable and slow-moving inventory.

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

Trademarks — Trademarks acquired in connection with the Acquisition are being amortized on a straight-line basis over 40 years. The Company periodically evaluates the recoverability of trademarks based on an analysis of estimated future undiscounted cash flows.

Deferred Financing Costs — Deferred financing costs are being amortized over the term of the related debt agreements.

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

Income Taxes — The Predecessor Company filed a consolidated federal tax return with BHI and, as agreed, the consolidated provision for income taxes was allocated between the Predecessor Company and BHI based on their pro rata share of consolidated income before income taxes, which approximates the provision for income taxes as determined on a separate company basis. 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.

Foreign Currency Translation — The Company uses the U.S. 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 operations.

Foreign Exchange Contracts — The Company imports certain product from Taiwan. To hedge its foreign exchange exposure, the Company may enter into foreign exchange contracts. At December 31, 1994, the Company had non-deliverable Taiwan currency forward contracts aggregating $32,500 which mature from January 1995 to December 1995. At December 31, 1994, the Company had deferred gains of $241 in connection with these contracts. These gains will be recognized and included in cost of sales at the time the related inventory is sold.

Notes to Consolidated Financial Statements

(In thousands, except share and per share amounts)

Fair Value of Financial Instruments — The carrying amount of cash and cash equivalents approximates fair value because of the short-term nature of these instruments. The Company believes that it was not practicable to estimate the fair value of the subordinated debentures at January 1, 1994 because of 1) the fact that they were issued in connection with the issuance of the original equity of the Company at the date of acquisition as an investment unit, 2) the related-party nature of the securities, 3) the lack of comparable securities, and 4) the lack of a credit rating of the Company by an established rating agency. In February 1995, the Company refinanced its subordinated debentures. Although the fair value of the subordinated debentures could have been impacted by their related party nature, based on the refinancing, the Company believes the fair value of the subordinated debentures approximated their carrying value as of December 31, 1994. The fair value of the Company's forward currency contracts is determined using the current spot rate. The fair value and carrying amount of such contracts were $433 and $192 at December 31, 1994 and $268 and $0 at January 1, 1994, respectively.

Net Income (Loss) Per Share — Net income (loss) per share is based on the weighted average number of common and common equivalent shares outstanding during the period. Common equivalent shares consist of the Company's common stock issuable upon exercise of common stock options, determined using the treasury stock method. All common stock options granted by the Company prior to the Company's initial public offering (June 17, 1993) have been included in the calculation of common and common equivalent shares outstanding as if they were outstanding for all periods presented.

3. PROPERTY AND EQUIPMENT

Property and equipment is comprised of the following:

	Dec. 31, 1994	Jan. 1, 1994
Leasehold improvements	$ 1,172	$ 688
Furniture and fixtures	2,588	2,050
Equipment	4,207	2,638
Building	5,876	5,861
Land	906	906
	14,749	12,143
Less accumulated depreciation	(2,419)	(1,235)
Property and equipment, net	$12,330	$10,908

4. OTHER CURRENT LIABILITIES

Other current liabilities are comprised of the following:

	Dec. 31, 1994	Jan. 1, 1994
Accrued compensation and benefits	$1,161	$1,059
Income taxes payable	5,143	4,875
Accrued stock issuance costs	853	1,605
Other	1,858	1,018
	$9,015	$8,557

The Company accrued $2,200 of liabilities for future stock issuance costs in connection with its initial capitalization. During 1993, the Company revised its estimate of future stock issuance costs in connection with its initial capitalization and, as a result, recorded an additional $1,500 for future stock issuance costs.

5. CREDIT AGREEMENT

Long-term debt is comprised of the following:

	Dec. 31, 1994	Jan. 1, 1994
Revolving line of credit	$ 13,000	$ –
Term loan	100,000	–
Subordinated debentures	–	148,000
	113,000	148,000
Less current portion	20,000	–
	$ 93,000	$148,000

During February 1995, the principal operating subsidiary of the Company, D 56, Inc., entered into a credit agreement providing a $100,000 term loan and a revolving line of credit. In connection therewith, the Company will record an extraordinary charge of $1,312, net of tax, to write off deferred financing costs during the first quarter of 1995. The proceeds of the term loan, combined with $8,000 from the revolving line of credit was used to refinance $108,000 of subordinated debentures. The subordinated debentures outstanding as of December 31, 1994 have been reclassified to reflect the refinancing. The term loan is due and payable in five consecutive annual installments of $20,000, payable on December 31 of each year commencing December 31, 1995.

(In thousands, except share and per share amounts)

The revolving line of credit provides for borrowings of up to $90,000, 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 $20,000 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 ¼% to ⅜% 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 Eurodollar Rate (as defined) plus an applicable margin or the Alternate Base Rate (as defined). The applicable margin ranges from ½% to 1¼% for Eurodollar loans. The credit agreement expires December 31, 1999.

The credit agreement includes restrictions as to, among other things, the amount of additional indebtedness, liens, contingent obligations, investments, capital expenditures and dividends. The credit agreement also requires maintenance of minimum levels of interest coverage, net worth and liquidity. 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 $12,182, $17,595 and $497 during the years ended December 31, 1994 and January 1, 1994 and the period from October 4, 1992 to January 2, 1993, respectively. The Predecessor Company paid $769 during the period from December 29, 1991 to October 3, 1992. The weighted average interest rate on outstanding short-term borrowings at December 31, 1994 was 8.5%.

In connection with the Acquisition, the Company issued $213,000 of 7% subordinated debentures to MBO-IV, which is an affiliate of FL & Co., and such subordinated debentures were then immediately distributed to the limited partners of such limited partnership, none of which are affiliates of the Company or of FL & Co. The Company prepaid $40,000 and $65,000 of the subordinated debentures on December 30, 1994 and December 31, 1993, respectively.

6. INCOME TAXES

The provision (benefit) for income taxes consisted of the following:

	Company			Predecessor Company
	Year Ended Dec. 31, 1994	Year Ended Jan. 1, 1994	Oct. 4, 1992 through Jan. 2, 1993	Dec. 29, 1991 through Oct. 3, 1992
Current:				
Federal	$22,339	$16,680	$ 403	$ 7,303
State	2,298	1,333	35	695
Foreign	246	342	–	–
Deferred	203	(682)	(462)	(1,111)
	$25,086	$17,673	$ (24)	$ 6,887

Notes to Consolidated Financial Statements

(In thousands, except share and per share amounts)

	Company			Predecessor Company
	Year Ended Dec. 31, 1994	Year Ended Jan. 1, 1994	Oct. 4, 1992 through Jan. 2, 1993	Dec. 29, 1991 through Oct. 3, 1992
Income taxes (benefit) at federal statutory rate (35% in 1994 and 1993 and 34% in prior periods)	$21,414	$14,935	$(371)	$2,467
State income taxes net of federal income tax	1,929	1,300	(33)	218
Amortization of goodwill and other intangibles	1,448	1,440	358	–
Adjustment to deferred tax assets and liabilities for the change in the federal tax rate	–	111	–	–
Costs incurred by Predecessor Company in connection with the sale of D 56, Inc. for which no income tax benefit was recorded	–	–	–	4,139
Other	295	(113)	22	63
Provision (benefit) for income taxes	$25,086	$17,673	$ (24)	$6,887

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

	Dec. 31, 1994	Jan. 1, 1994
Deferred tax assets:		
Accounts receivable valuation allowances	$ 1,988	$ 1,817
Inventory valuation allowances	822	774
Compensation expense—common stock options	345	269
Accrued liabilities	115	197
Other	49	33
Total deferred tax assets	3,319	3,090
Deferred tax liabilities:		
Trademarks	(6,419)	(6,589)
Property and equipment	(929)	(381)
Other	(158)	(104)
Total deferred tax liabilities	(7,506)	(7,074)
	$(4,187)	$(3,984)

The $4,187 net deferred tax liability at December 31, 1994 is presented as a net deferred current asset of $3,161 and a deferred noncurrent liability of $7,348. The $3,984 net deferred tax liability at January 1, 1994 is presented as a net deferred current asset of $2,986 and a deferred noncurrent liability of $6,970.

The Company paid income taxes of $23,677, $15,228 and $384 during the years ended December 31, 1994 and January 1, 1994 and the period from October 3, 1992 to January 2, 1993, respectively. The Predecessor Company paid income taxes of $10,640 during the period from December 29, 1991 to October 3, 1992.

7. PERFORMANCE BONUSES

The Predecessor Company had employment agreements with certain of its officers. Compensation under these agreements included aggregate performance bonuses equal to 15% of pretax income (as defined). These agreements were terminated in connection with the Acquisition.

8. COMMITMENTS

Operating Leases — The Company leases an aircraft, warehouse and office space, equipment, and showroom display facilities under operating leases ranging from three to 12 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.

Notes to Consolidated Financial Statements

(In thousands, except share and per share amounts)

The following is a schedule of future annual minimum lease payments for noncancelable operating leases as of December 31, 1994:

1995	$ 2,592
1996	2,529
1997	2,315
1998	2,334
1999	2,055
Thereafter	2,382
	$14,207

The Company's rental expense was $2,359, $1,534 and $292 for the years ended December 31, 1994 and January 1, 1994 and the period from October 4, 1992 to January 2, 1993, respectively. The Predecessor Company's rental expense was $845 for the period from December 29, 1991 to October 3, 1992.

Letters of Credit — The Company had outstanding standby and commercial letters of credit amounting to $9,038 at December 31, 1994 relating to purchase commitments issued to foreign suppliers and vendors and to certain banks.

9. 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. The Company's total profit sharing contributions were $819, $783 and $195 for the years ended December 31, 1994 and January 1, 1994 and the period from October 4, 1992 to January 2, 1993, respectively. The Predecessor Company's contribution for the period from December 29, 1991 to October 3, 1992 was $446.

10. NONRECURRING CHARGES

The Predecessor Company incurred certain one-time costs in connection with the sale of D 56, Inc. to the Company. These costs are comprised of payments to terminate employment contracts and special bonuses of $25,000 and costs incurred by the Predecessor Company in connection with the sale of D 56, Inc. of $3,350.

11. RELATED-PARTY TRANSACTIONS

In the ordinary course of business, the Company sells product to a floral and nursery wholesaler and retailer, of which a director of the Company is an officer, director and stockholder. The Company had sales to this floral and nursery business during the years ended December 31, 1994 and January 1, 1994 and the period from October 4, 1992 to January 2, 1993 of $1,494, $1,458 and $468, respectively. The Predecessor Company had sales to this floral and nursery business of $1,041 during the period from December 29, 1991 to October 3, 1992.

During the years ended December 31, 1994 and January 1, 1994, the Company paid FL & Co. and its affiliates $1,549 and $252, respectively, for aircraft management, transportation and other expenses.

In February 1994, the Company entered into an agreement with an affiliate of FL & Co. to purchase a corporate aircraft for $6,650. The Company assigned the purchase agreement to an unaffiliated third party and entered into an operating lease of the aircraft from such third party following the assignment.

The Predecessor Company purchased imported merchandise from Fifty-Six Trading Co., Ltd., a Taiwan-based trading company, in the amount of $31,813 during the period from December 29, 1991 to October 3, 1992. Two officers and stockholders of the Company were the principal stockholders of Fifty-Six Trading Co., Ltd. As of the date of the Acquisition, the Company purchased the assets, subject to certain liabilities, of Fifty-Six Trading Co., Ltd. (See Note 1).

12. STOCKHOLDERS' EQUITY

Public Offerings — On June 17, 1993, FL & Co. and certain members of senior management and other employees of the Company sold in an initial public offering (the "June Offering") 5,290,000 shares of the Company's common stock, par value $.01 per share (the "Common Stock"), at an initial public offering price of $18.00 per share.

On May 5, 1994, FL & Co. and certain members of senior management and other employees completed a public offering of 5,750,000 shares of the Company's common stock at a price of $27.375 per share.

(In thousands, except share and per share amounts)

Stock Options — In October 1992, the Company adopted a stock option plan ("1992 Stock Option Plan") which provides for granting stock options to directors, officers, and key employees. A total of 292,500 shares of Common Stock are reserved for issuance under the stock option plan. In October 1992 and February 1993, pursuant to this plan, options to purchase 22,500 and 225,000 shares, respectively, were granted. The options have a term of 10 years, are exercisable in equal installments on each of the first, second, and third anniversaries of the date of the grant, and have an exercise price of $3.33 per share.

Under the 1992 Stock Option Plan, options to purchase 81,501 and 35,144 shares of Common Stock were exercised during the years ended December 31, 1994 and January 1, 1994, respectively. At December 31, 1994, options to purchase 10,855 shares of Common Stock were exercisable at $3.33 per share.

In December 1992, the Company granted options to purchase 30,000 shares of Common Stock to each of four members of the Company's Board of Directors. 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 in equal installments on each of the first, second, and third anniversaries of the date of the grant, have a term of 10 years, and have an exercise price of $3.33 per share. Directors' options to purchase 10,000 shares were exercised during the year ended December 31, 1994. At December 31, 1994, directors' options to purchase 80,000 shares of Common Stock were exercisable at $3.33 per share.

In April 1993, the Company adopted a stock incentive plan ("1993 Stock Option Plan") which provides for granting stock options, stock appreciation rights and various other awards to officers, employees, consultants and advisors to the Company. A total of 1,000,000 shares of Common Stock are reserved for issuance under this plan.

Options granted under this plan have an exercise price equal to the market value at the date of grant ($18.00 to $37.75), have a term of 10 years and are exercisable in equal installments on each of the first, second and third anniversaries of the date of grant. Information regarding the 1993 Stock Option Plan is as follows:

Year ended	Dec. 31, 1994	Jan. 1, 1994
Outstanding at beginning of year	192,200	–
Granted	424,700	198,900
Exercised	(40,900)	–
Cancelled	(4,100)	(6,700)
Outstanding at end of year	571,900	192,200
Exercisable at end of year	22,100	–

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 December 31, 1994 and January 1, 1994 and the related consolidated statements of operations, cash flows and stockholders' equity for the years ended December 31, 1994 and January 1, 1994 and the period from October 4, 1992 to January 2, 1993. We have also audited the consolidated statements of operations, cash flows and stockholders' equity of D 56, Inc. (the "Predecessor Company") for the period from December 29, 1991 to October 3, 1992. 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 December 31, 1994 and January 1, 1994 and the results of its operations and its cash flows for the years ended December 31, 1994 and January 1, 1994 and the period from October 4, 1992 to January 2, 1993 and the Predecessor Company's results of operations and cash flows for the period from December 29, 1991 to October 3, 1992 in conformity with generally accepted accounting principles.

Deloitte & Touche LLP
Minneapolis, Minnesota
February 17, 1995

Corporate and Stockholder Information

BOARD OF DIRECTORS

Edward R. Bazinet [1]
Chairman of the Board and
Chief Executive Officer,
Department 56, Inc.

Todd L. Bachman
Chairman and Chief
Executive Officer,
Bachman's, Inc.

Nicholas C. Forstmann [1, 3]
General Partner,
Forstmann Little & Co.

Theodore J. Forstmann
General Partner,
Forstmann Little & Co.

Stephen Fraidin
Partner,
Fried, Frank, Harris,
Shriver & Jacobson

Richard S. Friedland [2]
President and Chief
Operating Officer,
General Instrument Corporation

Sandra J. Horbach [1]
General Partner,
Forstmann Little & Co.

Wm. Brian Little [1]
Private Investor

Steven G. Rothmeier [2]
Chairman of the Board
and Chief Executive Officer,
Great Northern Capital

Arthur T. Shorin [2, 3]
Chairman of the Board
and Chief Executive Officer,
The Topps Co. Inc.

Vin Weber [3]
Vice Chairman,
Empower America

[1] Member of Executive Committee
[2] Member of Audit Committee
[3] Member of Compensation Committee

OFFICERS

Edward R. Bazinet
Chief Executive Officer

Susan E. Engel
President and Chief Operating Officer

David H. Weiser
Vice President, General Counsel
and Secretary

David W. Dewey
Vice President–Overseas Operations

William E. Kirchner
Vice President–Product Development
and Advertising

Sing F. Lo
Vice President–Management
Information Systems

Robert S. Rose
Vice President–Distribution and
Operations

Timothy J. Schugel
Controller and Principal
Accounting Officer

Joan M. Serena
Vice President–Consumer Services

STOCKHOLDER INFORMATION

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New York, NY 10001

Attorneys
Fried, Frank, Harris, Shriver &
Jacobson

Independent Accountants
Deloitte & Touche LLP

Stock Listing
New York Stock Exchange Symbol
"DFS"

Annual Meeting
10:00 a.m.
May 18, 1995
Chemical Bank
270 Park Avenue
New York, NY

Department 56, Inc. Market Price
(Per Share)

1994	High	Low
First Quarter	$35	$26
Second Quarter	$33⅞	$26¾
Third Quarter	$39	$31½
Fourth Quarter	$40	$34
1993		
Second Quarter	$24	$18⅝
Third Quarter	$27	$21⅞
Fourth Quarter	$29⅞	$24⅛

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 21, 1995, there were 723 record holders of the Company's common stock.

Department 56, Inc. and its subsidiaries employ more than 200 persons worldwide.

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Department 56

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Eden Prairie, MN 55344, USA