Tradition of Growth

Annual Report 1996

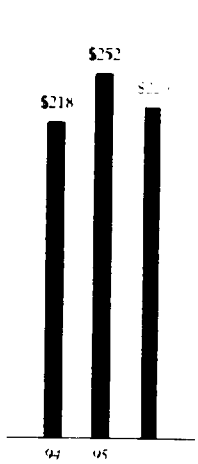
Department 56 Inc.

Department. 56, Inc. is a leading designer and marketer of lighted ceramic and porcelain houses and accessories, and an extensive array of holiday and decorative products for the home. We partner with manufacturers to cost-effectively produce fine-quality, handcrafted products, which are sold through more than 19,000 leading gift, home accessory, specialty and department store retailers across the United States. Founded in 1976, Department 56 is headquartered in Eden Prairie, Minnesota, and employs over 200 people worldwide.

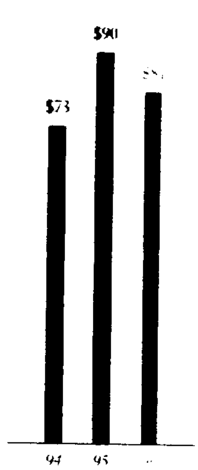
FINANCIAL HIGHLIGHTS

(Dollars in thousands, except per share amounts)	*1996*	*1995*	*1994*
Net Sales	$228,775	$252,047	$217,865
Income From Operations*	80,702	89,573	72,977
Net Income*	45,669	47,856	36,099
Net Income Per Share*	2.10	2.20	1.67
Working Capital	$ 67,997	$ 36,015	$ 13,362
Total Assets	285,733	259,085	239,680
Long-Term Debt	60,000	80,000	113,000
Stockholders' Equity	196,757	150,286	100,305

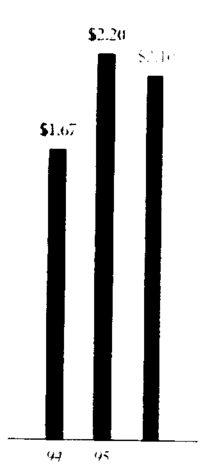
NET SALES
(Dollars in millions)



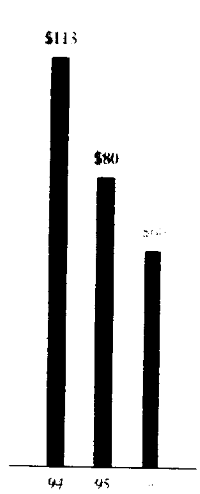
INCOME FROM OPERATIONS*
(Dollars in millions)



NET INCOME PER SHARE*



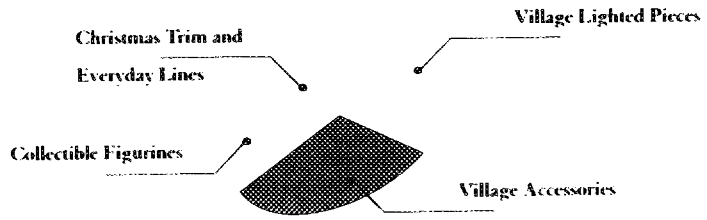
LONG-TERM DEBT
(Dollars in millions)

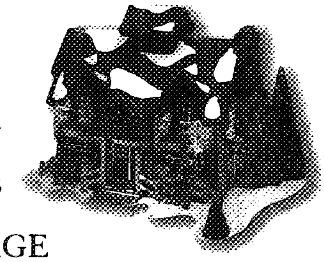


Product Overview

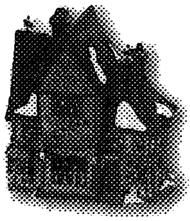
Department 56 currently offers more than 3,000 products of which more than 25% are new in 1996. Our annual product introductions and retirements create continuity and vitality among our core product lines, including lighted Village houses and accessories, Snowbabies and Snowbunnies.

1996 Sales Distribution





Since the ORIGINAL SNOW VILLAGE® was introduced in 1976, a total of 201 lighted pieces have been issued. There are currently 37 pieces outstanding and 164 retired lighted pieces. The HERITAGE VILLAGE COLLECTION® was introduced in 1984 with the introduction of our Dickens' Village Series.® Since then, we have added several Village series including New England Village,® Alpine,™ The Little Town of Bethlehem, Christmas in the City® and North Pole.™ In total, 240 Heritage Village pieces have been introduced, of which 89 are current and 151 retired. Related VILLAGE ACCESSORIES include landscape accessories such as trees, mountains, snow and lights, as well as 155 current and 170 retired ceramic or porcelain accessory pieces.



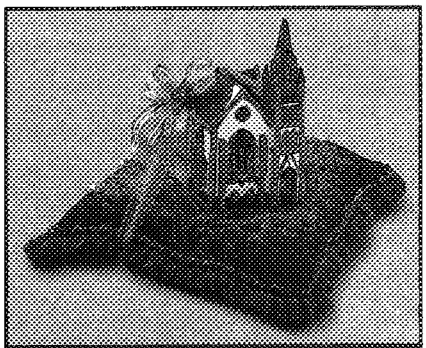
COLLECTIBLE FIGURINES include SNOWBABIES™ which were introduced in 1986 with a total of 110 bisque pieces. Currently, 61 pieces are available with 49 pieces now retired. SNOWBUNNIES™ were introduced in 1994 with a total of 40 pieces in the collection. Thirty-five are currently available and five are retired. Our CHRISTMAS TRIM AND EVERYDAY lines include ongoing lines such as our Mercury Glass ornaments, Noel ornaments, and our Silver Collection. Fa La La™ and Buzz™ lines are representative of the fresh and exciting new lines we introduce each year.

Chairman's Letter to Shareholders

TRADITION MEANS A LOT TO THE PEOPLE OF DEPARTMENT 56. I am proud of the growing role our products play in the holiday traditions of millions of families. I am also proud of the Company's extraordinary financial achievements over the years. The financial results experienced in 1996 and what early indications suggest for 1997 reflect efforts by Department 56 and its dealers to address retail inventory levels, not a reversal of our ability to reach new consumers. Department 56 continues its Tradition of Growth among consumers and, in our view, is poised to resume its Tradition of Growth in 1998 and beyond.

I am confident in our future because market research suggests underlying consumer demand for our collectible products continues to grow. This, however, may not be clear if you only look at our financial results. Investors naturally have questions. The Company's strategy and operations will be highlighted in the next section of this report by Susan Engel.

Reliable and predictable free cash flow is one of the exceptional financial characteristics that Department 56 enjoys. Even in this year of transition, Department 56's net after-tax margin was 20 percent of sales – a level well above that achieved by most consumer products companies. Reflecting our confidence in the future, the Board of Directors authorized on December 10, 1996 a stock repurchase program covering up to 1.5 million shares.



All Saints Corner Church

In 1996, the Department 56 management team took the difficult steps necessary to preserve the value of our unique consumer franchise and achieved admirable financial results in the process of doing so. This team has developed a variety of initiatives designed to accelerate the company's future growth.

I am pleased that Susan Engel recently assumed the additional responsibilities of Chief Executive Officer. While continuing as Chairman, I will be focusing my attention on creative development of our Decorative Giftware line. For me, this is a homecoming of sorts. Before Department 56 became known for our Collectible products, my roots started in general giftware and home decor. I look forward to concentrating on growing our Decorative Giftware line. I am confident taking this step into a new role at Department 56 because a management team of proven strength is in place.

Department 56 was founded on the premise that a company that added the greatest value through its own creative energies could capture the hearts and minds of consumers. Our concept has been proven by our unmatched success. Perpetually shared with family and friends, our products have become a new tradition. We are grateful to the many consumers whose relationships with our products have created our Tradition of Growth at Department 56 and look forward to continuing to build these relationships for many years to come.

Edward R. Bazinet

Edward R. Bazinet
Chairman of the Board

A Review of Strategy and Operations

Susan Engel – President and Chief Executive Officer

CONSUMER DEMAND IS GROWING according to recent surveys of dealers and avid consumers, conducted by independent market research organizations. Their results confirmed what our conversations with dealers had suggested – dealers not only reported higher sales in 1996, but also expect consumer sales to be up again in 1997. In addition, a majority of avid consumers surveyed also said that they bought more village pieces in 1996 than the prior year.

ALTHOUGH CONSUMER DEMAND SHOWS GROWTH, DEALERS ARE ORDERING LESS IN 1997.

Dealers are ordering smarter. They are reordering less, ordering it later, and putting a greater emphasis on newly introduced products. Dealers demonstrated strong demand for new pieces in 1996, as they continue to do in the first quarter of 1997. They are substantially meeting consumer demand for older product with inventory they had accumulated over several years. In large part, this is the expected result of procedures we implemented late in 1995 and throughout 1996 to help our retailers become more efficient in ordering. Dealers may also be adjusting to our improved shipping ability by shifting some of their first quarter orders to later quarters.

Snowbabies

RETAIL INVENTORIES ON CURRENT PRODUCT ARE MEASURABLY DOWN.

Strong consumer response to 1996 retirements, as well as strong sell-through of our 1996 introductions, contributed to a reduction in retail inventory levels. In January 1997, we introduced fewer Village pieces in the interest of balancing the emphasis at retail between new and existing pieces, and thereby further supporting retailers' efforts to reduce inventories. At the same time, we have embarked on several marketing initiatives to increase demand.

MULTIPLE APPROACHES INCREASE DEMAND FOR PRODUCTS.

Satisfying existing collectors is essential to increasing consumer demand. We are very pleased with recent market research that indicates existing collectors maintain a keen interest and enthusiasm for building their collections. A mix of collector shows, our Web site, videos, seminars and limited editions, all serve to reinforce collectors' interest. About 60 percent of the surveyed collectors increased their purchases of Department 56 Village pieces in 1996, while purchases decreased for only approximately 8 percent. This continuing enthusiasm by collectors is gratifying.

Additionally, we see a potential market for our products that exceeds our current base of consumers. We are reaching out to expose new consumers to our product by using innovative methods to attract them through our current dealer base and by using some new channels of distribution. Additionally, Department 56 continues to develop licensed products with high-profile American brands that serve to expose our products to new consumers and encourage trial in both current and new channels.

DEPARTMENT 56 IS REACHING NEW CONSUMERS THROUGH ITS CURRENT DEALER BASE WITH A THREE-PRONG MARKETING STRATEGY.

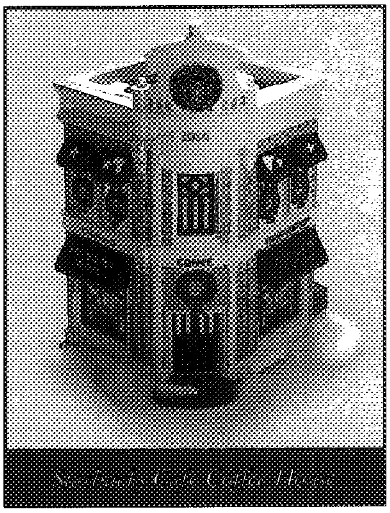
Our new consumer marketing strategies are all based on the premise of making buying decisions easy for the consumer. First, to help the first-time buyer create a warm Christmas display for themselves or give as a gift, we created starter sets consisting of lit pieces and appropriate accessories, all packaged together.

Second, we have encouraged our retailers to develop in-store "vignettes" which are limited groups of pieces occupying smaller spaces. Vignettes represent a ready-to-go decorating idea that appeal to the casual consumer, while demonstrating new product usage possibilities to our collectors.

Importantly, dealers expect consumer sales to be up again in 1997.

Third, we are encouraging retailers to merchandise individual pieces as the perfect stand-alone gift tailored to the individual interests of the recipient, whether they are a collector or noncollector. For example, Hollydale's Department Store piece is perfect for the avid shopper, while our brokerage house appeals to those with financial interests.

AFFILIATIONS WITH HIGH-PROFILE BRANDS ATTRACT NEW CONSUMERS THROUGH TRADITIONAL CHANNELS.



Partnering with high-profile brands taps strong consumer interest in those brands, creating "points of entry" for new consumers while reinforcing the excitement of existing collectors. Our Snow Village piece depicting a Starbucks® café appeals to coffee aficionados. The appeal of our Coca-Cola® bottling plant and accessory pieces went beyond existing Department 56 consumers to new consumers who are loyal to the Coca-Cola brand and already predisposed to collecting. Looking forward, we are pleased to announce our affiliation with Harley-Davidson.® A motorcycle shop and related accessories were introduced in 1997. Feverishly high brand loyalty is a hallmark of Harley-Davidson fans.

DEPARTMENT 56 HAS INTRODUCED NEW VEHICLES TO COMMUNICATE TO DEALERS AND CONSUMERS.

We improved the tools we use to communicate with consumers and dealers. *OnTime*, introduced in 1996 is a bimonthly dealer publication that presents new merchandising concepts, from new display ideas to sales associate selling tips. The Department 56 Web site, introduced in October 1996, serves as the definitive source of product and dealer information on the World Wide Web. With "hot links" to topics like "decorating," "holiday" and "gift," the site is designed to attract new consumers and provide comprehensive outreach to established collectors. The success of the site is evidenced by almost one-half million visits in the first four months of operations. During this period, visitors spent an average of 24 minutes at the site – longer than the average Internet visit.

Notably, one of the site's most popular pages has been the dealer locator, with 68,000 hits already logged. The dealer locator page, along with most of the 60,000 calls last year to our toll-free phone hotline, directs consumers to retail stores that carry our product.

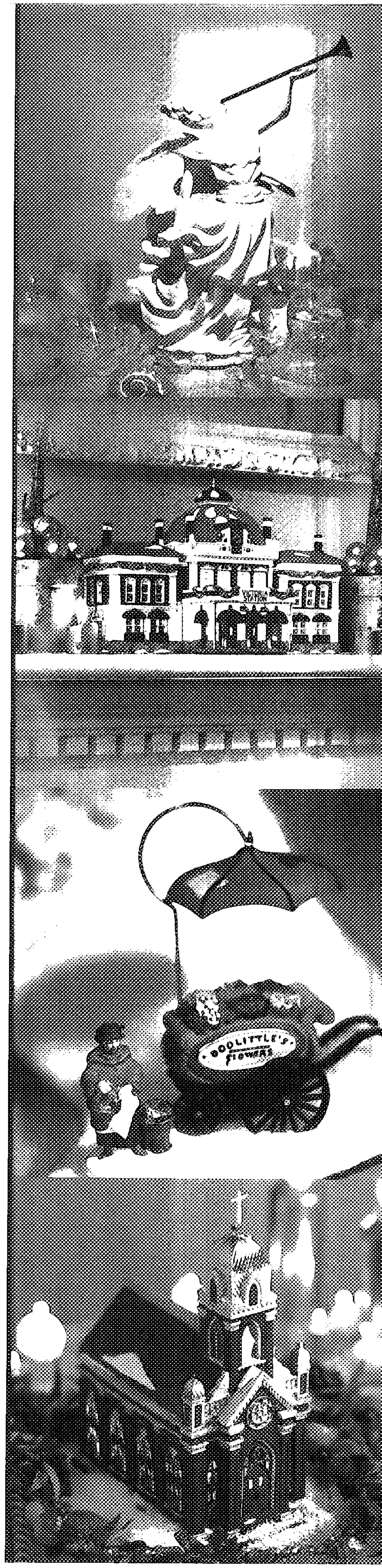
IN 1996, WE TESTED THREE NEW NON-TRADITIONAL CHANNELS THAT WE WILL EXPAND IN 1997.

A variety of new channels have already begun to generate product exposure and purchases. Incentive programs, the corporate gift market and home television shopping are all resulting in growing interest from new consumers and ultimately, are designed to generate added business for our existing dealers.

These are perfect opportunities for Department 56 to profit while planting the seeds of future growth. Because only a small percentage of American households own a Department 56 piece, these programs primarily distribute pieces to first-time recipients. A product insert encourages consumers to register with us to increase the likelihood they will become collectors. We intend to provide this information to the dealer for follow-up. After all, it's the dealers adding their personal touch and customer service that turns consumers into collectors.

DEPARTMENT 56 PRODUCTS USED AS INCENTIVES OFFER COMPANIES AN OPPORTUNITY TO BUILD A MEANINGFUL PROGRAM THAT HAS UNIVERSAL APPEAL.

For the supermarket incentive program of a major food company, existing pieces were the perfect gift for store and department managers. Looking forward, a national marketing company serving realtors will include Village pieces in a gift basket program for new home buyers. Gaining product trial that could lead to a lifetime tradition at this early lifestyle stage is an exciting prospect for us. The broad assortment of Department 56 houses provides the ability to develop a unique incentive program that has high perceived value and can continue over a number of years.



DEPARTMENT 56 CAN SERVE THE CORPORATE GIFT MARKET MUCH AS IT CAN THE INCENTIVE MARKET.

For example, Heinz® asked Department 56 to design and manufacture a replica of the original H.J. Heinz house for their corporate gift program. As in the incentive programs, for most recipients, these corporate gifts are their first Department 56 piece. We believe that many will choose to build a Village collection around it. Since the products are not part of our Village lines, corporate gifts are unlikely to dilute consumer demand for products sold in our traditional channels. Most importantly, replicas and unique pieces as corporate gifts are more than a new channel. They represent a whole new market that leverages our creative design and sourcing capabilities.

The Heinz success and many potential corporate gift and incentive programs have driven us to launch a new replica brand called Profiles.™ We are already seeing significant opportunities in this new market for the future.

A DECEMBER HOME TELEVISION SHOPPING TEST OF VILLAGE PRODUCT WAS QUITE SUCCESSFUL WITH QVC.

QVC Network, the upscale home shopping network, was pleased with strong viewer response and has expressed interest in continuing to distribute our products. Consumer research suggests that the offering was one of our more successful efforts in reaching first-time consumers. We offered through QVC a limited number of prepackaged sets of products. Products selected for this promotion had been available for some time, so the sales lost by our traditional dealers were minimal, while new collectors generated will be a source of new business for our dealers in the future.

THESE EFFORTS HAVE PROVED EFFECTIVE IN ATTRACTING NEW CONSUMER INTEREST.

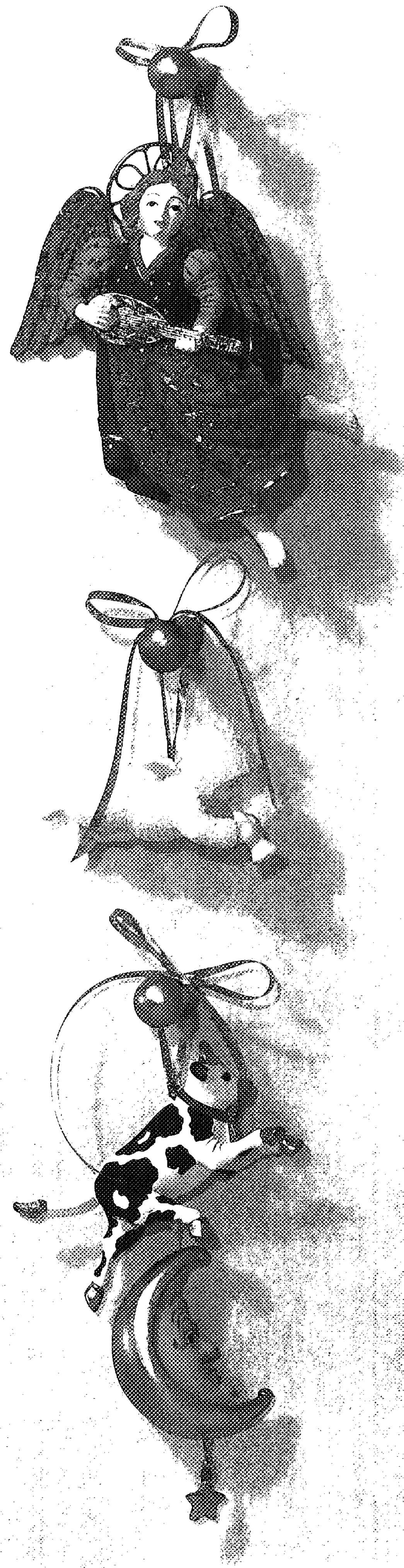
The results have been extremely positive. Our marketing efforts appear to be bearing fruit, as dealers cite new collectors as a significant reason for their growth in independent market research studies. We are encouraged about our ability to expand these efforts in 1997 and even more so in 1998.

DEPARTMENT 56 HAS DEVELOPED A NUMBER OF INTERNATIONAL ALLIANCES TO TEST AND CAPTURE INTERNATIONAL DEMAND.

Geographic expansion is a long-term source of growth. There are a variety of strong consumer markets where our market penetration is very low. We made significant progress in Europe in 1996 by forging alliances with two leading companies. Goebel – the manufacturer of Hummel® figurines – has been appointed to distribute Department 56 product on the Continent, while Enesco will represent us in the U.K. We also have established distributors in Canada and Brazil. The need for deliberate growth when expanding into new geography – involving the education of dealers and consumers about our product – moderates the short-term impact of this attractive source of long-term growth.

DEPARTMENT 56 IS A SOLID INVESTMENT.

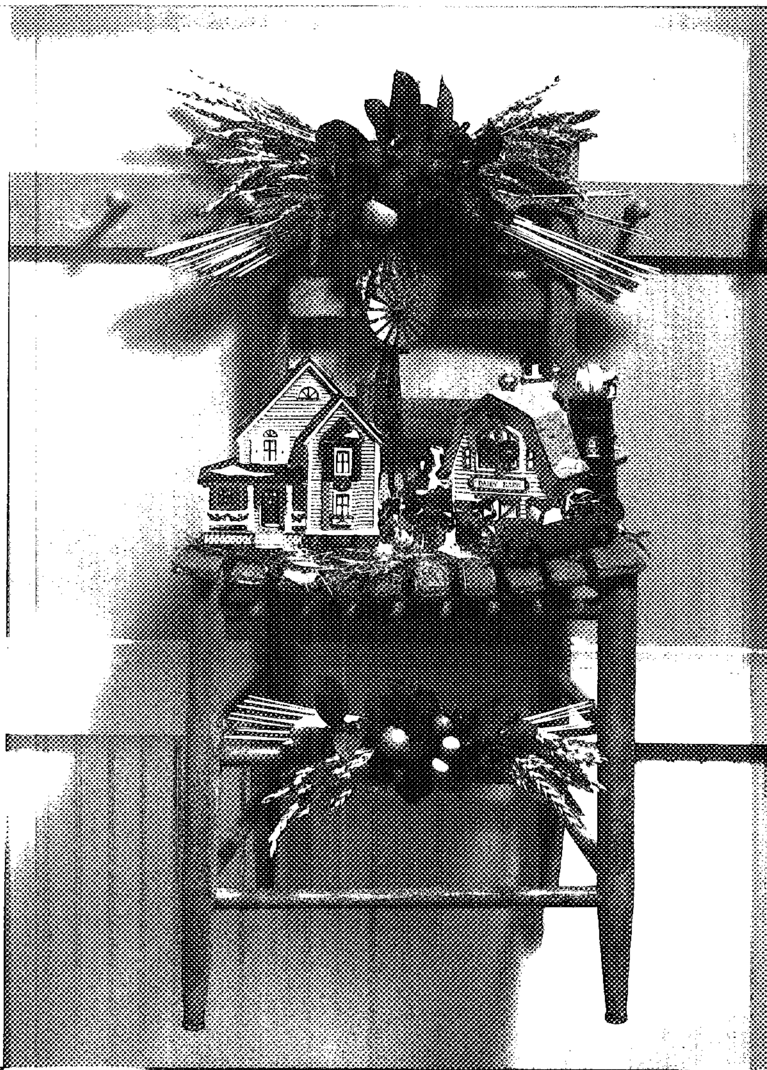
We have a unique product franchise built on family holiday traditions and our commitment to preserving collectible integrity. We also have distinctly attractive financial characteristics. A strong consumer bond to our proprietary designs yields exceptional profitability. Outsourced manufacturing arrangements result in minimal capital requirements while sustaining consistent profitability and strong cash flow. These strengths have resulted in twenty years of exceptional growth for Department 56. We are confident that our Tradition of Growth will continue.

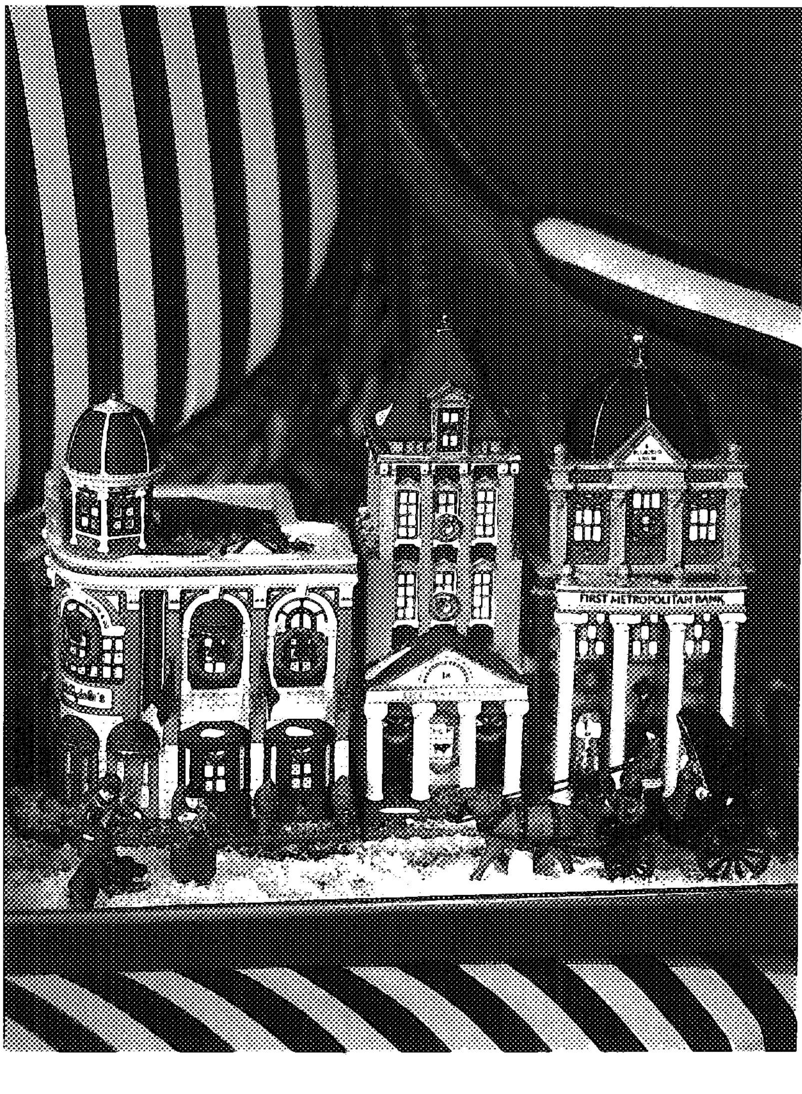


Summary…

DISTINCTLY ATTRACTIVE FINANCIAL CHARACTERISTICS

- Department 56 has consistently achieved profitability ratios among the best of all consumer product companies.
- Attractive margins are a function of Department 56's unique franchise and strong sourcing capabilities, which allows the Company to offer products with detail and quality at a price unmatched in our market.
- By outsourcing manufacturing, the Company's growth does not require significant capital expenditures. Moreover, variable unit costs are held constant, giving management flexibility to match product supply to market demand, while maintaining gross margins.
- By owning most concepts in the best-selling collectible products, Department 56's own creative efforts sustain product longevity and add value to the franchise.
- Department 56 generates strong and predictable free cash flow. Department 56 can use the cash to enhance shareholder return, whether through reducing interest expense, repurchasing shares or investing in new business opportunities.





…Reasons to Invest

A UNIQUE FRANCHISE

- Holiday traditions drive recurring demand for products.
- Family involvement creates new generations of consumers.
- Retirements and limited editions create ongoing product excitement, reinforcing collector interest.
- Product designs are innovative and proprietary.
- Consistent designs and themes are recognized by consumers.
- Unique franchise with twenty-year history.
- Surveys continue to show high rate of consumer satisfaction.
- Selective distribution commands attractive product display at retail level.

NOTE CONCERNING FORWARD-LOOKING STATEMENTS

The statements throughout this annual report relating to matters that are not historical facts are "forward-looking statements" that involve risks and uncertainties. Among other assumptions, the forward-looking statements regarding retail inventory levels and consumer demand are based on market research conducted for the Company and assume that consumer demand and retail inventory levels will follow the findings of, and dealer statements made in, this research. Moreover, these forward-looking statements are also based on retail inventory reports from certain dealers of the Company's products and assume that such reports were correct when made and are reflective of the market as a whole. General and giftware industry economic and competitive conditions are also assumed to remain stable.

Actual results may vary from these forward-looking statements and the assumptions on which they are based. The company undertakes no obligation to update such forward-looking statements or publish any forward-looking statements in the future.

Five-Year Summary

(In thousands, except per share amounts)	Company: Year ended Dec. 28, 1996[1]	Company: Year ended Dec. 30, 1995[1]	Company: Year ended Dec. 31, 1994[1]	Company: Year ended Jan. 1, 1994[1]	Company: Year ended Jan. 2, 1993[1,2] (pro forma for the Acquisition)	Company: Oct. 4, 1992–Jan. 2, 1993	Predecessor Company: Dec. 29, 1991–Oct. 3, 1992
STATEMENTS OF OPERATIONS							
Net sales	$228,775	$252,047	$217,865	$184,359	$150,754	$ 24,600	$125,713
Cost of sales	95,190	110,008	98,480	87,331	74,958	12,967	62,485
Gross profit	133,585	142,039	119,385	97,028	75,796	11,633	63,228
Operating expenses:							
Selling, general and administrative	48,306	47,889	41,831	34,670	29,151	7,537	20,678
Performance bonuses[3]	—	—	—	—	450	—	6,658
Amortization of goodwill and trademarks	4,577	4,577	4,577	4,575	4,568	1,150	—
Nonrecurring charges[4]	—	—	—	—	—	—	28,350
Recovery of import duties[5]	(453)	(2,872)	—	—	—	—	—
Total operating expenses	52,430	49,594	46,408	39,245	34,169	8,687	55,686
Income from operations	81,155	92,445	72,977	57,783	41,627	2,946	7,542
Other expense (income):							
Interest expense	6,063	9,582	12,629	16,143	16,339	4,341	790
Other, net	(648)	(439)	(837)	(1,030)	(1,044)	(304)	(503)
Income (loss) before income taxes and extraordinary item	75,740	83,302	61,185	42,670	26,332	(1,091)	7,255
Provision (benefit) for income taxes	29,796	33,737	25,086	17,673	11,168	(24)	6,887
Income (loss) before extraordinary item	45,944	49,565	36,099	24,997	15,164	(1,067)	368
Extraordinary charge due to refinancing of debt[6]	—	1,312	—	—	—	—	—
Net income (loss)	$ 45,944	$ 48,253	$ 36,099	$ 24,997	$ 15,164	$ (1,067)	$ 368
Income (loss) before extraordinary item per share	$ 2.11	$ 2.28	$ 1.67	$ 1.16	$ .70	$ (.05)	—
Net income (loss) per share	$ 2.11	$ 2.22	$ 1.67	$ 1.16	$ .70	$ (.05)	—

BALANCE SHEET DATA	Dec. 28, 1996	Dec. 30, 1995	Dec. 31, 1994	Jan. 1, 1994	Jan. 2, 1993
Working capital	$ 67,997	$ 36,015	$ 13,362	$ 26,392	$ 61,697
Total assets	285,733	259,085	239,680	234,893	275,370
Long-term debt, including current maturities	60,000	80,000	113,000	148,000	213,000
Total stockholders' equity[7]	196,757	150,286	100,305	61,731	37,158

[1] *The years ended January 1, 1994, December 31, 1994, December 30, 1995 and December 28, 1996 were 52-week periods and the year ended January 2, 1993 was a 53-week period.*

[2] *In October 1992, D 56, Inc. (the "Predecessor Company") was acquired by corporations formed by affiliates of Forstmann Little & Co. (the "Acquisition"). 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.*

[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.*

[4] *Nonrecurring charges include payments to terminate employment contracts, special bonuses and costs incurred by the Predecessor Company in connection with the Acquisition.*

[5] *Reflects refunds of custom duties and interest that the Company received related to certain merchandise imported into the United States from 1989 to 1994. (See Note 8 to the Consolidated Financial Statements.)*

[6] *Reflects an extraordinary charge the Company incurred in connection with its refinancing of debt. (See Note 4 to the Consolidated Financial Statements.)*

[7] *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. 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

COMPARISON OF RESULTS OF OPERATIONS 1996 TO 1995

Net Sales Net sales decreased $23.3 million, or 9%, from $252.0 million in 1995 to $228.8 million in 1996. This decrease was due principally to a decrease in volume. Sales of Village Series products decreased 12% from 1995 to 1996, while General Giftware product sales decreased 3% during the same period. Village Series products continued to account for the most significant portion of the Company's sales, 67% in 1996 versus 69% in 1995.

Gross Profit Gross Profit decreased $8.5 million, or 6%, between 1995 and 1996. Gross profit as a percentage of sales increased from approximately 56% in 1995 to approximately 58% in 1996, principally due to increased manufacturing efficiencies and lower volume discounts as a percent of sales.

Selling, General and Administrative Expenses Selling, general and administrative expenses increased $.4 million, or 1%, between 1995 and 1996 principally due to an 18% increase in marketing expense and inflationary increases in administrative expenses, offset by a 7% decrease in commission expense. Selling, general and administrative expenses as a percentage of sales increased from approximately 19% in 1995 to approximately 21% in 1996.

Recovery of Import Duties, Net The Company received net refunds of $.5 million and $2.9 million in custom duties and related interest during 1996 and 1995, respectively. The duties pertained to certain merchandise imported into the United States from 1989 to 1994.

	1996		1995		1994	
(In millions, except per share amounts)	*Dollars*	*Percent of Net Sales*	*Dollars*	*Percent of Net Sales*	*Dollars*	*Percent of Net Sales*
Net sales	$228.8	100%	$252.0	100%	$217.9	100%
Gross profit	133.6	58	142.0	56	119.4	55
Selling, general and administrative expenses	48.3	21	47.9	19	41.8	19
Amortization of goodwill and trademarks	4.6	2	4.6	2	4.6	2
Recovery of import duties	(.5)	—	(2.9)	(1)	—	—
Income from operations	81.2	35	92.4	37	73.0	33
Interest expense	6.1	3	9.6	4	12.6	6
Other, net	(.6)	—	(.4)	—	(.8)	—
Income before income taxes and extraordinary item	75.7	33	83.3	33	61.2	28
Provision for income taxes	29.8	13	33.7	13	25.1	12
Income before extraordinary item	45.9	20	49.6	20	36.1	17
Extraordinary charge due to refinancing of debt	—	—	1.3	1	—	—
Net income	45.9	20	48.3	19	36.1	17
Income before extraordinary item per share	2.11		2.28		1.67	
Net income per share	2.11		2.22		1.67	
Operating cash flow[1]	88.1		99.1		79.7	

[1] *Earnings before interest, income tax, depreciation and amortization expenses.*

Income from Operations Income from operations decreased $11.3 million, or 12%, from 1995 to 1996 due to the factors described above. Operating margins decreased from 37% of net sales in 1995 to 35% of net sales in 1996.

Interest Expense Interest expense decreased $3.5 million, or 37%, between 1995 and 1996 principally due to the prepayment of $33 million of debt during 1995, decreased interest rates in 1996 and reduced borrowings under the revolving line of credit in 1996.

Provision for Income Taxes The effective income tax rate was 40.5% and 39.3% during 1995 and 1996, respectively.

COMPARISON OF RESULTS OF OPERATIONS 1995 TO 1994

Net Sales Net sales increased $34.2 million, or 16%, from $217.9 million in 1994 to $252.0 million in 1995. This increase was due principally to an increase in volume. Sales of Village Series products increased 17% from 1994 to 1995, while General Giftware product sales increased 12% during the same period. Village Series products accounted for 69% of the Company's sales in both 1995 and 1994.

The increase in the sales volume of Village Series products during 1995 resulted from continued strong customer demand which was supported by the introduction of new lighted pieces.

In General Giftware products, sales increased at a lower rate than the Company's overall sales due principally to a reduction in the growth rate of the Company's Christmas Trim products.

Gross Profit Gross Profit increased $22.7 million, or 19%, between 1994 and 1995. Gross profit as a percentage of sales increased from approximately 55% in 1994 to approximately 56% in 1995, principally as a result of reduced import duties resulting from the United States' implementation of GATT, effective January 1, 1995 and certain manufacturing efficiencies.

Selling, General and Administrative Expenses Selling, general and administrative expenses increased $6.1 million, or 14%, between 1994 and 1995, 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 typically vary in proportion to the Company's sales.

Recovery of Import Duties, Net The Company received a net refund of $2.9 million in custom duties and related interest during 1995. The duties pertained to certain merchandise imported into the United States from 1989 to 1994.

Income from Operations Income from operations increased $19.5 million, or 27%, from 1994 to 1995 due to the factors described above. Operating margins increased from 33% of net sales in 1994 to 37% of net sales in 1995.

Interest Expense Interest expense decreased $3.0 million, or 24%, between 1994 and 1995 due to the prepayment of $40 million of long-term debt on December 31, 1994.

Provision for Income Taxes The effective income tax rate was 41.0% and 40.5% during 1994 and 1995, respectively.

Extraordinary Charge due to Refinancing of Debt The Company refinanced its long-term debt in February, 1995. In connection therewith, the Company recorded an extraordinary charge of $1.3 million, net of a tax benefit of $0.9 million, or $0.06 per share.

Management's Discussion and Analysis

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 71% and 76% of its total annual customer orders for 1996 and 1995, respectively, during the first quarter of each of those years. Cancellations of total annual customer orders were approximately 6% and 7% in 1996 and 1995, respectively. The Company's backlog was $7.2 million and $11.0 million at December 28, 1996 and December 30, 1995, respectively.

The Company shipped and recorded as net sales approximately 92% and 91% of its annual customer orders in 1996 and 1995, 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 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.

	1996					1995				
(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]	$177.5	$35.3	$28.3	$7.7	$248.8	$209.9	$30.0	$27.3	$8.6	$275.8
Net sales	59.0	75.3	60.2	34.3	228.8	53.0	74.8	77.0	47.2	252.0
Gross profit	33.8	44.3	34.8	20.7	133.6	29.7	42.4	43.6	26.3	142.0
Selling, general and administrative expenses	11.5	13.0	11.7	12.1	48.3	10.0	12.2	11.8	13.9	47.9
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
Recovery of import duties, net	(.2)	—	(.3)	—	(.5)	—	—	(2.8)	(.1)	(2.9)
Income from operations	21.4	30.2	22.2	7.4	81.2	18.5	29.1	33.4	11.4	92.4
Income before extraordinary item	12.2	17.3	12.3	4.1	45.9	9.9	15.9	18.2	5.6	49.6
Net income	12.2	17.3	12.3	4.1	45.9	8.6	15.9	18.2	5.6	48.3
Income before extraordinary item per share	0.56	0.79	0.57	0.19	2.11	0.46	0.73	0.84	0.25	2.28
Net income per share	0.56	0.79	0.57	0.19	2.11	0.40	0.73	0.84	0.25	2.22

[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.*

Management's Discussion and Analysis

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 recorded 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 installments of $20 million, payable in December of each year. At December 28, 1996, the term loan outstanding was $60 million.

The Company believes that its internally generated cash flow and seasonal borrowings under the revolving line of credit will be adequate to fund operations, capital expenditures, and required principal payments on its term loan for the next twelve 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., the Company's principal operating subsidiary, is required to satisfy consolidated net worth, interest coverage ratio and current ratio tests, in each case at the end of each fiscal quarter. The available borrowings under the revolving line of credit were $87,615,000 at December 28, 1996.

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 bad debt experience relating to these accounts receivable has not been material.

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. Cash and cash equivalents balances increased from $7.8 million at December 30, 1995 to $46.4 million at December 28, 1996 principally due to the increase in net cash provided by operating activities and a decrease in net principal payments on long-term debt in 1996 as compared to 1995.

Accounts receivable increased from $34.3 million at December 30, 1995 to $35.6 million at December 28, 1996 principally due to a higher percentage of 1996 sales qualifying for extended terms.

During 1996, the Company reduced its inventory levels as a result of the decrease in sales volume in 1996 as compared to 1995 and took a more cautious approach to inventory purchases. Inventories decreased from $29.1 million at December 30, 1995 to $20.5 million at December 28, 1996.

Capital expenditures were $1.5 million, $1.6 million and $2.6 million for 1996, 1995 and 1994, respectively.

Operating cash flow, defined as earnings before interest, income tax, depreciation and amortization expenses, decreased $11.0 million, or 11%, from $99.1 million in 1995 to $88.1 million in 1996. The decrease was principally due to the decrease in income from operations.

On December 10, 1996, the Board of Directors of the Company authorized a stock repurchase program. The program allows the repurchase in the open market of up to 1.5 million shares through the end of June 1998. The timing, prices and number of shares repurchased will be determined at the discretion of the Company's management based on its view of prevailing economic and market conditions.

Management's Discussion and Analysis

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 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.

Subsequent to December 28, 1996, the Company entered into $15.0 million of foreign exchange contracts to hedge 1997 New Taiwan dollar denominated inventory purchases. These contracts mature from January 1997 through December 1997 at a rate of approximately 27.50 NT$/US$.

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 20, 1997, the Company issued a press release stating, in relevant part: " 'During [1996] we took some tough, but necessary steps to strengthen and protect our unique collectible brands by responding to excess retail inventory levels. Although substantial efforts were taken in 1996 to reduce inventory at retail, 1997 will continue to be a year of transition, as retailers work to further reduce their inventory,' [said Susan Engel, President and CEO of Department 56].

As a result, dealer orders through February 15, 1997, are down 11% against the comparable period last year. While orders for new product introductions continue to be strong, first quarter reorders of existing products are down as dealer inventory levels are sufficient for many items. Also, the company purposely introduced fewer new Village pieces in January in order to balance the emphasis at retail between new and existing pieces with the goal of advancing the inventory reduction process. 'We attribute the decline in orders to date primarily to a necessary and healthy correction in retail inventory levels,' Engel commented.

In addition, Engel said, 'independent research suggests continuing growth in underlying consumer demand, as well as progress already made toward retail inventory reduction, supporting our confidence in the future.' Engel cited five findings:

- Retail sales of Department 56 collectible lines grew in 1996;
- Dealers expect continued retail sales growth in 1997;
- Dealers cite new collectors as an important reason for their growth;
- Existing collectors continue to show enthusiasm for Department 56 collectible lines;
- Dealers experienced a reduction in their retail inventory levels of current product."

Management's Discussion and Analysis

The Private Securities Litigation Reform Act of 1995 (the "Act") provides "safe harbor" status to certain statements that go beyond historical information and which may provide an indication of future results. The press release further stated: "The statements in this press release relating to matters that are not historical facts are 'forward-looking statements' that involve risks and uncertainties. Among other assumptions, the forward-looking statements regarding retail inventory levels and consumer demand are based on market research conducted for the Company and assume that consumer demand and retail inventory levels will follow the findings of, and dealer statements made in, this research. Moreover, these forward-looking statements are also based on retail inventory reports from certain dealers of the Company's products and assume that such reports were correct when made and are reflective of the market as a whole. General and giftware industry economic conditions are also assumed to remain stable.

Actual results may vary from these forward-looking statements and the assumptions on which they are based. The forward-looking statements in this press release speak as of this date only. The Company undertakes no obligation to update such forward-looking statements or publish any forward-looking statements in the future."

Consolidated Balance Sheets

(In thousands, except per share amounts)	December 28, 1996	December 30, 1995
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 46,405	$ 7,805
Accounts receivable, net of allowances of $10,264 and $6,884, respectively	35,603	34,271
Inventories	20,526	29,059
Deferred taxes	5,048	4,476
Other current assets	1,721	2,068
Total current assets	109,303	77,679
Property and equipment, net	12,318	12,445
Goodwill, net of accumulated amortization of $17,554 and $13,425, respectively	147,620	151,749
Trademarks, net of accumulated amortization of $1,902 and $1,454, respectively	15,998	16,446
Other assets	494	766
	$285,733	$259,085
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Current portion of long-term debt	$ 20,000	$ 20,000
Accounts payable	7,618	6,599
Commissions payable	4,683	4,471
Other current liabilities	9,005	10,594
Total current liabilities	41,306	41,664
Deferred taxes	7,670	7,135
Long-term debt	40,000	60,000
Commitments (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 21,584 and 21,546 shares, respectively	216	215
Additional paid-in capital	42,315	41,803
Unearned compensation on common stock options	—	(14)
Retained earnings	154,226	108,282
Total stockholders' equity	196,757	150,286
	$285,733	$259,085

See notes to consolidated financial statements.

Consolidated Statements of Income

(In thousands, except per share amounts)	Year ended December 28, 1996	Year ended December 30, 1995	Year ended December 31, 1994
Net sales	$228,775	$252,047	$217,865
Cost of sales	95,190	110,008	98,480
Gross profit	133,585	142,039	119,385
Operating expenses:			
Selling, general and administrative	48,306	47,889	41,831
Amortization of goodwill and trademarks	4,577	4,577	4,577
Recovery of import duties	(453)	(2,872)	—
Total operating expenses	52,430	49,594	46,408
Income from operations	81,155	92,445	72,977
Other expense (income):			
Interest expense	6,063	9,582	12,629
Other, net	(648)	(439)	(837)
Income before income taxes and extraordinary item	75,740	83,302	61,185
Provision for income taxes	29,796	33,737	25,086
Income before extraordinary item	45,944	49,565	36,099
Extraordinary charge due to refinancing of debt	—	1,312	—
Net income	$ 45,944	$ 48,253	$ 36,099
Income before extraordinary item per share	$ 2.11	$ 2.28	$ 1.67
Net income per share	$ 2.11	$ 2.22	$ 1.67
Weighted average common and common equivalent shares outstanding	21,759	21,747	21,649

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

(In thousands)	Year ended December 28, 1996	Year ended December 30, 1995	Year ended December 31, 1994
Cash Flows from Operating Activities:			
Net income	$ 45,944	$ 48,253	$ 36,099
Adjustments to reconcile net income to net cash provided by operating activities:			
Extraordinary charge	—	1,312	—
Depreciation	1,721	1,609	1,296
Amortization of goodwill, trademarks and other assets	4,577	4,577	5,254
Provision for uncollectible accounts receivable	2,014	2,293	1,107
Compensation expense – common stock options	14	169	498
Deferred taxes	(37)	(1,528)	203
Changes in assets and liabilities:			
Accounts receivable	(3,349)	(12,605)	(11,511)
Inventories	8,533	(8,693)	(2,971)
Other assets	502	520	(361)
Accounts payable	1,019	1,442	11
Commissions payable	212	262	590
Other current liabilities	(1,379)	1,766	1,179
Net cash provided by operating activities	59,771	39,377	31,394
Net Cash used in Investing Activities:			
Purchases of property and equipment	(1,507)	(1,617)	(2,621)
Cash Flows from Financing Activities:			
Proceeds from the exercise of common stock options	336	865	1,041
Borrowings on revolving credit agreement	34,338	36,500	97,577
Principal payments on revolving credit agreement	(34,338)	(41,500)	(92,577)
Proceeds from issuance of long-term debt	—	100,000	—
Principal payments on long-term debt	(20,000)	(128,000)	(40,000)
Net cash used in financing activities	(19,664)	(32,135)	(33,959)
Net increase (decrease) in cash and cash equivalents	38,600	5,625	(5,186)
Cash and cash equivalents at beginning of period	7,805	2,180	7,366
Cash and cash equivalents at end of period	$ 46,405	$ 7,805	$ 2,180

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*	*Retained Earnings*	*Total Stockholders' Equity*
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
Net income	—	—	—	—	48,253	48,253
Shares issued upon the exercise of common stock options	71	—	1,559	—	—	1,559
Common stock options vested	—	—	—	169	—	169
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

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

Business 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.

Principles of Consolidation The accompanying consolidated financial statements of the Company include the accounts of the Company and its subsidiaries, which include D 56, Inc., Browndale Tanley Limited and Department 56 Trading Co., Ltd., all of which are wholly owned. 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 years ended December 31, 1994, December 30, 1995 and December 28, 1996 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 sheets.

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 China, Taiwan and other Pacific Rim countries. Each period the Company provides for identified, unsaleable 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 forty-five 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 income.

Goodwill 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 40 years. The Company periodically evaluates the recoverability of goodwill based on an analysis of estimated future undiscounted cash flows.

Trademarks Trademarks acquired 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.

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

Income Taxes 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 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.

(In thousands, except share and per share amounts)

Foreign Exchange Contracts The Company imports certain product from Taiwan. 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 transaction being hedged. Subsequent to December 28, 1996, the Company entered into nondeliverable Taiwan currency forward contracts with a notional amount of $15,000 which mature from January 1997 to December 1997. 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.

Fair Value of Financial Instruments 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. The fair value and carrying amount of such contracts were $(77) and $0 at December 30, 1995. There were no forward currency contracts outstanding at December 28, 1996.

Net Income per Share Net income 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.

Management Estimates 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 period. Actual results could differ from those estimates.

2 PROPERTY AND EQUIPMENT

Property and equipment is comprised of the following:

	Dec. 28, 1996	Dec. 30, 1995
Leasehold improvements	$ 2,156	$ 2,020
Furniture and fixtures	4,025	2,983
Equipment	4,756	4,518
Building	5,882	5,882
Land	906	906
	17,725	16,309
Less accumulated depreciation	5,407	3,864
Property and equipment, net	$12,318	$12,445

3 OTHER CURRENT LIABILITIES

Other current liabilities are comprised of the following:

	Dec. 28, 1996	Dec. 30, 1995
Accrued compensation and benefits	$1,281	$ 1,370
Income taxes payable	5,893	6,917
Accrued royalty fees	593	1,245
Other	1,238	1,062
	$9,005	$10,594

(In thousands, except share and per share amounts)

4 CREDIT AGREEMENT

Long term debt is comprised of the following:

	Dec. 28, 1996	Dec. 30, 1995
Term loan	$60,000	$80,000
Less current portion	20,000	20,000
	$40,000	$60,000

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 recorded an extraordinary charge of $1,312, net of tax, to write off deferred financing costs during the first quarter of 1995. The term loan is due and payable in annual installments of $20,000, payable in December of each year.

The revolving line of credit provides for borrowings of up to $90,000, which may be in the form of letters of credit, banker's 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 1/4% to 3/8% per annum on the daily average of the unused commitment. The available borrowings under the revolving line of credit were $87,615 at December 28, 1996.

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 1/2% to 1 1/4% 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 $6,129, $10,086 and $12,182 during the years ended December 28, 1996, December 30, 1995 and December 31, 1994, respectively.

5 INCOME TAXES

The provision for income taxes, excluding the $893 tax benefit from the extraordinary charge due to the refinancing of debt in 1995, consisted of the following:

	Year Ended Dec. 28, 1996	Year Ended Dec. 30, 1995	Year Ended Dec. 31, 1994
Current:			
Federal	$27,376	$30,560	$22,339
State	2,347	2,619	2,298
Foreign	110	272	246
Deferred	(37)	286	203
	$29,796	$33,737	$25,086

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 Dec. 28, 1996	Year Ended Dec. 30, 1995	Year Ended Dec. 31, 1994
Income taxes at federal statutory rate	$26,509	$29,156	$21,414
State income taxes, net of federal income tax	1,893	2,566	1,929
Amortization of goodwill	1,448	1,448	1,448
Other	(54)	567	295
Provision for income taxes	$29,796	$33,737	$25,086

(In thousands, except share and per share amounts)

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

	Dec. 28, 1996	Dec. 30, 1995
Deferred tax assets:		
Accounts receivable valuation allowances	$ 3,516	$ 2,704
Inventory valuation allowances	1,118	1,369
Compensation expense – common stock options	331	366
Accrued liabilities	354	620
Other	263	310
Total deferred tax assets	5,582	5,369
Deferred tax liabilities:		
Trademarks	(6,079)	(6,249)
Property and equipment	(1,986)	(1,626)
Other	(139)	(153)
Total deferred tax liabilities	(8,204)	(8,028)
	$(2,622)	$(2,659)

The $2,622 net deferred tax liability at December 28, 1996 is presented as a net deferred current asset of $5,048 and a net deferred noncurrent liability of $7,670. The $2,659 net deferred tax liability at December 30, 1995 is presented as a net deferred current asset of $4,476 and a net deferred noncurrent liability of $7,135.

The Company paid income taxes of $28,943, $31,855 and $23,677 during the years ended December 28, 1996, December 30, 1995 and December 31, 1994, respectively.

6 COMMITMENTS

Operating Leases The Company leases an aircraft, 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 December 28, 1996:

1997	$ 2,704
1998	2,623
1999	2,119
2000	2,469
2001	2,719
Thereafter	2,107
	$14,741

The Company's rental expense was $3,238, $2,875 and $2,359 for the years ended December 28, 1996, December 30, 1995 and December 31, 1994, respectively.

Letters of Credit The Company had outstanding standby and commercial letters of credit amounting to $2,385 at December 28, 1996 relating primarily to purchase commitments issued to foreign suppliers and vendors.

Legal Proceedings 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. The Company's total profit sharing contributions were $750, $975 and $819 for the years ended December 28, 1996, December 30, 1995 and December 31, 1994, respectively.

8 RECOVERY OF IMPORT DUTIES

During the years ended December 28, 1996 and December 30, 1995, the Company received net refunds of custom duties and related interest of $453 and $2,872, respectively. The refunds pertained to certain merchandise imported into the United States from 1989 to 1994.

(In thousands, except share and per share amounts)

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 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 28, 1996, December 30, 1995 and December 31, 1994 of $1,305, $1,893 and $1,494, respectively.

During the years ended December 28, 1996, December 30, 1995 and December 31, 1994, the Company paid Forstmann Little & Co. ("FL & Co."), a shareholder, and its affiliates $2,116, $2,537 and $1,549, 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.

10 STOCK-BASED COMPENSATION PLANS

At December 28, 1996, the Company had three stock-based compensation plans. Under the 1992, 1993 and 1995 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 and 600,000 shares of common stock, respectively. All 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.

A summary of the status of the Company's three stock option plans as of December 28, 1996, December 30, 1995 and December 31, 1994, and changes during the years ended on those dates is presented below:

	1996		1995		1994	
Stock Options	*Shares*	*Weighted-Average Exercise Price*	*Shares*	*Weighted-Average Exercise Price*	*Shares*	*Weighted-Average Exercise Price*
Outstanding at beginning of year	1,072,773	$31.73	702,755	$26.32	404,556	$10.30
Granted	433,350	20.48	448,660	37.13	424,700	36.28
Exercised	(33,500)	9.36	(70,742)	12.23	(122,401)	8.23
Forfeited	(180,715)	39.09	(7,900)	31.26	(4,100)	18.00
Outstanding at end of year	1,291,908	27.51	1,072,773	31.73	702,755	26.32
Options exercisable at end of year	536,583		224,271		32,955	
Weighted average fair value of options granted during the year	$10.75		$16.07			

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 1995 and 1996 stock option grants consistent with the method of Statement of Financial Accounting Standards No. 123 "Accounting for Stock-Based Compensation" (SFAS 123), the Company's income before extraordinary item, net income, income before extraordinary item per share and net income per share would have been reduced to the pro forma amounts indicated below:

(In thousands, except share and per share amounts)

	Year Ended Dec. 28, 1996	*Year Ended Dec. 30, 1995*
Income before Extraordinary Item		
As reported	$45,944	$49,565
Pro forma	$43,410	$48,885
Net Income		
As reported	$45,944	$48,253
Pro forma	$43,410	$47,573
Income before Extraordinary Item per Share		
As reported	$2.11	$2.28
Pro forma	$2.00	$2.25
Net Income per Share		
As reported	$2.11	$2.22
Pro forma	$2.00	$2.19

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 1996 and 1995, respectively: expected volatility of 46% and 32%, risk-free interest rates of 5.8% and 6.0%, expected option lives of 6 years and no expected dividends. The effects of applying SFAS 123 in this pro forma disclosure are not indicative of future amounts. SFAS 123 does not apply to awards prior to 1995, and additional awards are anticipated.

The following table summarizes information about the Company's stock option plans at December 28, 1996:

Range of Exercise Prices	*Number Outstanding at Dec. 28, 1996*	*Weighted-Average Remaining Contractual Life*	*Weighted-Average Exercise Price*	*Number Exercisable at Dec. 28, 1996*	*Weighted-Average Exercise Price*
$ 3.33	81,013	6.1 years	$ 3.33	81,013	$ 3.33
18.00-20.50	517,815	8.7	20.05	90,500	18.00
34.63-37.75	693,080	8.1	35.91	365,070	36.08
	1,291,908			536,583	

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, and have an exercise price of $3.33 per share. Shares purchased under these options are subject to director stockholder agreements which limit the transferability of the shares. At December 28, 1996, directors' options to purchase 135,000 shares of Common Stock were exercisable at $3.33 per share.

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 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.

Edward R. Bazinet

Edward R. Bazinet
Chairman of the Board

Susan E. Engel

Susan E. Engel
President 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 December 28, 1996 and December 30, 1995 and the related consolidated statements of income, cash flows and stockholders' equity for the years ended December 28, 1996, December 30, 1995 and December 31, 1994. 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 28, 1996 and December 30, 1995 and the results of its operations and its cash flows for the years ended December 28, 1996, December 30, 1995 and December 31, 1994 in conformity with generally accepted accounting principles.

Deloitte & Touche LLP

Minneapolis, Minnesota
February 14, 1997

BOARD OF DIRECTORS

Edward R. Bazinet
Chairman of the Board
Department 56, Inc.

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

Susan E. Engel
President and Chief Executive Officer
Department 56, Inc.

Nicholas C. Forstmann
General Partner
Forstmann Little & Co.

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

Richard S. Friedland
Chairman of the Board and Chief Executive Officer
General Instrument Corporation

Sandra J. Horbach
General Partner
Forstmann Little & Co.

Wm. Brian Little
Private Investor

Steven G. Rothmeier
Chairman of the Board and Chief Executive Officer
Great Northern Capital

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

Vin Weber
Partner
Clark & Weinstock, Inc.

Member of Executive Committee
Member of Audit Committee
Member of Compensation Committee

OFFICERS

Edward R. Bazinet
Chairman of the Board

Susan E. Engel
President and Chief Executive Officer

David W. Dewey
Senior Vice President – Overseas Operations

Mark R. Kennedy
Senior Vice President and Chief Financial Officer

William E. Kirchner
Senior Vice President – Product Development

Robert S. Rose
Vice President – Distribution and Operations

Timothy J. Schugel
Vice President – Finance

Joan M. Serena
Vice President – Consumer & Dealer Marketing

Gregory G. Sorensen
Vice President – Management Information Systems

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

STOCKHOLDER INFORMATION

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

Transfer Agent
Chase Mellon
Shareholder Services
450 West 33rd Street
New York, NY 10001

Independent Auditors
Deloitte & Touche LLP

Stock Listing
New York Stock Exchange
Symbol "DFS"

Annual Meeting
1:00 p.m.
May 15, 1997
Chase Manhattan Bank
270 Park Avenue
New York, NY

Department 56, Inc. Market Price *(Per Share)*

1996	High	Low
First Quarter	$41 7/8	$20
Second Quarter	$26 1/2	$20
Third Quarter	$25 [illegible]	$19 [illegible]
Fourth Quarter	$25 [illegible]	$21 [illegible]

1995	High	Low
First Quarter	$40 [illegible]	$33 [illegible]
Second Quarter	$42	$35 [illegible]
Third Quarter	$47 1/4	$37 [illegible]
Fourth Quarter	$48	$32 [illegible]

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 18, 1997, there were 1,067 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.

One Village Place 6436 City West Parkway Eden Prairie, MN 55344, USA
www.D56.com