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

**FORM 10-K**

(Mark One)

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (Fee Required) For the fiscal year ended December 30, 1995  
OR  
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (No Fee Required)  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-11908

PROCESSED BY

**DEPARTMENT 56, INC.**

(Exact name of registrant as specified in its charter)

MAR 30 1996

Delaware

(State or other jurisdiction of incorporation or organization)

13-3684956

(I.R.S. Employer Identification No.)

DISCLOSURE, INC.

One Village Place  
6436 City West Parkway

55344  
(Zip Code)

Eden Prairie, MN

(Address of principal executive offices)

(612) 944-5600

(Registrant's telephone number, including area code)

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

Title of each class

Name of each exchange  
on which registered

Common Stock, par value \$.01 per share

New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No   

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

The aggregate market value of the voting stock held by non-affiliates of the registrant was approximately \$394,684,417 as of March 20, 1996 (based on the closing price of consolidated trading in the Common Stock on that date as published in *The Wall Street Journal*). For purposes of this computation, shares held by affiliates and by directors and officers of the registrant have been excluded. Such exclusion of shares held by directors and officers is not intended, nor shall it be deemed, to be an admission that such persons are affiliates of the registrant.

Number of Shares of Common Stock, par value \$.01 per share, outstanding as of March 20, 1996: 21,548,887.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Company's Annual Report to Stockholders for the fiscal year ended December 30, 1995 (the "1995 Annual Report") are incorporated by reference in Parts II and IV. Portions of the Company's definitive Proxy Statement for the 1996 Annual Meeting of Stockholders filed with the Securities and Exchange Commission concurrently with this Form 10-K (the "1996 Proxy Statement") are incorporated by reference in Part III.

## PART I

### Item 1. BUSINESS

#### *General*

Department 56, Inc. (including its direct and indirect subsidiaries, "Department 56" or the "Company") 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 Village Series of collectible, handcrafted, lit ceramic and porcelain houses, buildings and related accessories in the Original Snow Village Collection and The Heritage Village Collection as well as its extensive line of holiday and home decorative accessories, including its Snowbabies collectible porcelain and pewter handpainted figurines.

The Company was organized in 1992 by affiliates of Forstmann Little & Co. ("Forstmann Little") for the purpose of acquiring (the "Acquisition") Department 56, Inc., a privately-held Minnesota corporation (the "Predecessor Company"). The Acquisition was consummated in October 1992 for an aggregate purchase price of approximately \$250 million (including the payment of expenses), plus the payment of approximately \$28 million of nonrecurring charges and approximately \$6 million of long-term indebtedness. The Acquisition was funded by the issuance of Common Stock for \$57.6 million (before the accrual of \$2.2 million for stock offering expenses) to affiliates of Forstmann Little (the "Forstmann Little Partnerships"), the issuance of Common Stock for approximately \$13.4 million (which consideration was primarily in the form of securities of the two stockholders of the Predecessor Company) to certain members of the senior management of the Company and the issuance of subordinated debentures of the Company for \$213 million to one of the Forstmann Little Partnerships. Subsequent to the Acquisition, the senior management of the Predecessor Company has continued as the senior management of the Company and the Predecessor Company, which changed its name to "D 56, Inc.," has continued as the Company's principal operating subsidiary.

In June 1993, the Forstmann Little Partnerships and certain members of senior management and other employees of the Company sold 5,290,000 shares of Common Stock in an initial public offering (the "Initial Public Offering") at a price of \$18.00 per share. In May 1994, the Forstmann Little Partnerships and certain members of senior management and other employees of the Company sold 5,750,000 shares of Common Stock in a public offering at a price of \$27.375 per share. In May 1995, the Forstmann Little Partnerships and a member of senior management of the Company sold 5,750,000 shares of Common Stock in a public offering at a price of \$37.625 per share. As of March 20, 1996, the Forstmann Little Partnerships owned approximately 11% of the outstanding shares of Common Stock.

#### *Products*

*Village Series Products.* Department 56 is best known for its Village Series, several series of collectible, handcrafted, lit ceramic and porcelain houses, buildings and related accessories that depict nostalgic winter scenes. The Company introduces new lit pieces, limited edition pieces, street lamps, figurines and other accessory groups each year to complement the collections. To allow for these new introductions and to keep each series appropriately balanced, the Company has traditionally retired a number of its existing pieces from production each year. Retirement decisions are based on management's judgment as to, among other things, expected consumer demand, whether a piece continues to fit the evolving design characteristics of a series and manufacturing considerations.

The Company's Village Series products are comprised of two broad collections: The Original Snow Village Collection and The Heritage Village Collection. The Original Snow Village Collection, introduced in 1976, consists of lit ceramic houses and accessories designed around a single "Main Street U.S.A." theme. The Heritage Village Collection, introduced in 1984 and expanded since that time, consists of lit porcelain houses and accessories designed around several different village themes. By using porcelain for The Heritage Village Collection products, the Company has been able to achieve a higher level of detail, in a smaller scale product, than would have been possible by using ceramic.

*Village Accessories.* Department 56 also produces a range of accessories for its villages, including figurines, vehicles, musical tapes, lighting and other decorative items. The sale of accessories for its Village Series is an important part of the Company's strategy to encourage the continued purchase of its products. Accessories allow collectors to refresh their collections by changing their displays and by creating personalized settings. Many of the accessories can be used interchangeably between the various villages, although certain accessories are designed uniquely for specific villages.

*General Giftware.* The Company offers a wide range of other decorative giftware and home accessory items, including the Company's Snowbabies and Snowbunnies figurines, Christmas and Easter decorative items, tableware, decorative tins, acrylics and gift bags. Department 56 develops these decorative giftware and home accessories both to satisfy specific consumer demand and to introduce new product concepts that may develop into important product lines for the Company in the future. Snowbabies figurines, originally introduced in 1987 as part of the Company's general Christmas collection, rapidly became a popular product line and subsequently have achieved their own collectible status. General Giftware products are generally offered as a line of products developed around a central design theme. The Company updates its product offerings twice a year and currently maintains an aggregate of approximately 2,500 stock keeping units, of which approximately 2,100 are General Giftware products.

#### *Customers*

The Company's principal customers (accounting for approximately 90% of its sales) are approximately 19,000 independent gift retailers across the United States. These retailers include approximately 1,300 independently owned Gold Key and Showcase Dealers, who receive special recognition and qualify for improved sales terms, and who must satisfy certain requirements, such as maintaining the Company's products on display in an attractive setting for at least six months. Occasionally, a piece will be sold exclusively through certain dealers in the first year that it is introduced. Approximately 10% of the Company's sales are made to department stores and mail order houses. No single account represented more than 2% of the Company's sales in fiscal 1995. The Company provides volume discounts to its customers with respect to most of its products. The Company has generally used its available production capacity to satisfy demand in the United States market and, accordingly, has had only limited sales outside the United States. International sales were approximately 1% of the Company's sales in fiscal 1995, and the Company does not expect to materially increase international sales in fiscal 1996.

As part of the Company's strategy of managed growth, only approximately 6,000 retailers receive the Company's Village Series and Snowbabies products. Due to strong demand, the Company's lit Village Series products and porcelain Snowbabies figurines have been sold on allocation for each of the last eight years and five years, respectively. In addition, the Company may also sell particular pieces or limited editions on an allocation basis, which may involve setting restrictions on how many pieces may be purchased by a particular customer. The Company periodically evaluates and adjusts its distribution network, and reviews its dealership policies with a view of optimizing both the Company's distribution strategy and the store-level operations of its independent dealers.

#### *Marketing and Advertising*

Department 56 sells its products through 13 independently operated wholesale showrooms (including showrooms in New York, Dallas and Los Angeles) and three corporate showrooms which cover the major giftware market areas in the United States. The Company's headquarters in Eden Prairie, Minnesota has a 10,000 square-foot atrium showroom where all of its products, including retired Village Series lighted pieces and Snowbabies figurines, are displayed. The Company also has a corporate showroom of approximately 10,200 square feet at the Atlanta, Georgia gift mart and a corporate showroom of approximately 7,500 square feet at the Chicago, Illinois gift mart. In addition, the Company sells through giftware shows throughout the United States. The Company intends to maintain flexibility in its marketing and distribution strategies in order to take advantage of opportunities that may develop in the future.

The Company advertises its products to retailers principally through trade journals, giftware shows and brochures. It advertises to consumers through brochures, point of sale information and seasonal advertisements in magazines and newspapers. The Company has also expanded its consumer advertising through use of cooperative advertising with its Gold Key Dealers using various media formats. In addition, the Company publishes and sells a quarterly newsletter, which contains product-related articles and description of its product lines, to subscriber groups and others. Department 56 maintains a toll-free telephone line for collector questions and participates in collector conventions.

#### *Design and Production*

The Company has an ongoing program of new product development. Each year, the Company introduces new products in its existing product lines and also develops entirely new product concepts. The Company endeavors to develop new products which, although not necessarily similar to the products currently marketed by the Company, fit the Company's quality and pricing criteria and can be distributed through the Company's existing marketing and distribution system.

Department 56 believes that its relationships with its manufacturers, and the quality of their craftsmanship, provide a competitive advantage and are a significant contributor to the Company's success. The Company imports most of its products from the Pacific Rim, primarily Taiwan (Republic of China), The People's Republic of China and The Philippines. The Company also imports a small percentage of its products from sources in Europe, primarily Italy, England and Germany. In fiscal 1995, the Company imported products from approximately 140 independent manufacturing sources. The Company's single largest manufacturing source represented approximately 8% of the Company's imports in fiscal 1995. The Company's emphasis on high quality craftsmanship at affordable prices limits the sources from which the Company chooses to obtain products and, accordingly, results in controlled growth of its product lines. The Company has long-standing relationships with the majority of its manufacturers (several for ten years or more) and often contracts (typically on a year-to-year basis) for a manufacturer's entire output for a year. As a result of these relationships, the Company has experienced a low turnover of its manufacturing sources.

The Company's wholly owned indirect subsidiary, Department 56 Trading Co., Ltd., the principal operations of which are based in Taiwan, sources many of the Company's products in the Pacific Rim, monitors and coordinates production and assists in the export of the Company's products to the United States. The Company believes that this overseas subsidiary provides the Company with greater product and quality control, at a lower cost, than would be available from a third party trading company. The Company also purchases products, to a limited extent, from selected independent trading companies operating in particular geographic regions.

The design and manufacture of the Company's Village Series products are complex processes. The path from final conception of the design idea to market introduction typically takes approximately 18 months. Products other than the Company's collectibles lines can generally be introduced within a few months after a decision is made to produce the product. The Company's Village Series products are principally composed of ceramic and porcelain clays and the Company's other products are designed in a variety of media, including paper, ceramic and porcelain.

#### *Distribution and Systems*

The products sold by the Company in the United States are generally shipped by ocean freight from abroad and then by rail to the Company's two automated warehouse and distribution centers, each located within 10 miles of the other in the southwest quadrant of the Minnesota Twin Cities metropolitan area. The Bloomington facility is dedicated to the warehousing and distribution of Village Series lit pieces, while the Eden Prairie facility handles all other products. Shipments from the Company to its customers are handled by United Parcel Service or commercial trucking lines.

The Company utilizes computer systems and internally developed software to maintain efficient order processing from the time a product enters the Company's system through shipping and ultimate payment collection from its customers. The Company also uses handheld optical scanners and bar

coded labels in accepting orders at wholesale showrooms throughout the United States. In addition, uniform computer and communication software systems allow on-line information access between the Company's headquarters and its showrooms, and those systems are being expanded to provide direct linkage with the Company's field salespersons. The Company believes its complex yet efficient software for the processing and shipment of orders from its central warehouse allows it to better serve its retail customer base.

#### *Backlog and Seasonality*

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 of each year as retailers stock merchandise in anticipation of the winter holiday season. The Company continues to ship merchandise until mid-December each year. Accordingly, the Company's backlog typically is lowest at the beginning of January. As of December 30, 1995, Department 56 had unfilled wholesale orders of approximately \$11.0 million, compared to \$8.4 million at December 31, 1994. All of the backlog is scheduled to be shipped to customers during the current fiscal year. Approximately 5% to 7% of the Company's total annual customer orders have been cancelled in each of the last three years for a number of reasons, including customer credit considerations, inventory shortages or customer cancellation requests.

Department 56 experiences a significant seasonal pattern in its working capital requirements and operating results. During the first quarter of each of the last three years, the Company received orders ranging from approximately 76% to 80% of its annual orders for such year. The Company offers extended payment terms to many of its customers for seasonal merchandise. Accordingly, the Company collects a substantial portion of its accounts receivable in the fourth quarter. Due to the seasonal pattern of shipping and accounts receivable collection, the Company generally has had greater working capital needs in its second and third quarters and has experienced greater cash availability in its fourth quarter. The Company typically finances its operations through net cash and marketable securities balances, internally generated cash flow and short-term seasonal borrowings. As a result of the Company's sales pattern, the Company typically records a substantial portion of its revenues in its second and third quarters. The Company expects this seasonal sales pattern to continue for the foreseeable future.

#### *Trademarks and other Proprietary Rights*

The Company owns seven Federal trademark registrations and has pending Federal trademark applications in the United States Patent and Trademark Office with respect to certain of its logos and brandnames. In addition, the Company from time to time registers selected trademarks in certain foreign countries.

Department 56 regards its trademarks and other proprietary rights as valuable assets and intends to maintain and renew its trademarks and their registrations and vigorously defend against infringement. The Federal registrations for the Company's trademarks are currently scheduled to expire or be cancelled at various times between 2002 and 2007, but can be maintained and renewed provided that the marks are still in use for the goods and services covered by such registrations.

#### *Competition*

Department 56 competes generally for the disposable income of consumers and, in particular, with other producers of fine quality collectibles, specialty giftware and home decorative accessory products. The collectibles area, in particular, is affected by changing consumer tastes and interests. The giftware industry is highly competitive, with a large number of both large and small participants. The Company's competitors distribute their products through independent gift retailers, department stores and mail order houses or through direct response marketing. The Company believes that the principal elements of competition in the specialty giftware industry are product design and quality, product and brand-name loyalty, product display and price. The Company believes that its competitive position is enhanced by a variety of factors, including the innovativeness, quality and enduring themes of the Company's products, its reputation among retailers and consumers, its in-house design

expertise, its sourcing and marketing capabilities and the pricing of its products. Some of the Company's competitors, however, are part of large, diversified companies having greater financial resources and a wider range of products than the Company.

#### *Restrictions on Imports*

The Company does not own or operate any manufacturing facilities and imports most of its products from manufacturers in the Pacific Rim, primarily Taiwan, The People's Republic of China and The Philippines. The Company also imports a small percentage of its products from sources in Europe, primarily Italy, England and Germany.

The Company's ability to import products and thereby satisfy customer orders is affected by the availability of, and demand for, quality production capacity abroad. The Company competes with other importers of specialty giftware products for the limited number of foreign manufacturing sources which can produce detailed, high-quality products at affordable prices. In addition, the Company's import operations may be adversely affected by political instability resulting in the disruption of trade from exporting countries, regulatory changes, increases in transportation costs or delays, any significant fluctuation in the value of the United States dollar against foreign currencies and restrictions on the transfer of funds.

Substantially all of the Company's products are subject to Customs Service duties and regulations pertaining to the importation of goods, including requirements for the marking of certain information regarding the country of origin on the Company's products. In the ordinary course of its business, from time to time, the Company is involved in disputes with the Customs Service regarding the amount of duty to be paid, the value of merchandise to be reported or other customs regulations with respect to certain of the Company's imports which may result in the payment of additional duties and/or penalties, or which may result in the refund of duties to the Company.

The United States and the countries in which the Company's products are manufactured may, from time to time, impose new quotas, duties, tariffs or other charges or restrictions, or adjust presently prevailing quotas, duty or tariff levels, which could adversely affect the Company's financial condition or results of operations or its ability to continue to import products at current or increased levels. In particular, the Company's costs may be increased, or the mix of countries from which it sources its products may be changed, in the future if countries which are currently accorded "Most Favored Nation" status by the United States cease to have such status or the United States imposes retaliatory duties against imports from such countries. In fiscal 1995, approximately 40% of the Company's imports were manufactured in The People's Republic of China, which is currently accorded "Most Favored Nation" status and generally is not subject to U.S. retaliatory duties. Various commercial and legal practices widespread in The People's Republic of China, including the handling of intellectual properties, as well as certain political and military actions taken by China in relation to Taiwan, are under review by the United States government and, accordingly, the duty treatment of goods imported from China is subject to political uncertainties. The Company cannot predict what regulatory changes may occur or the type or amount of any financial impact on the Company which such changes may have in the future.

#### *Employees*

As of December 30, 1995, the Company had 196 full-time employees in the United States and 9 full-time employees in Taiwan. All of the Company's 71 U.S.-based warehouse, shipping and receiving employees are represented by Local Union No. 638 of the Teamsters under a contract that expires on December 31, 1997. The Company believes that its labor relations are good and has never experienced a work stoppage.

#### *Environmental Matters*

The Company is subject to various Federal, state and local laws and regulations governing the use, discharge and disposal of hazardous materials. Compliance with current laws and regulations

has not had and is not expected to have a material adverse effect on the Company's financial condition. It is possible, however, that environmental issues may arise in the future which the Company cannot now predict.

#### **Item 2. PROPERTIES**

The Company owns a 67,000 square-foot office facility in Eden Prairie, Minnesota, which includes 57,000 square feet of office space. Its executive offices, creative center and primary corporate showroom are located in this facility, which is known as "One Village Place." The Company currently occupies approximately 57,500 square feet of the facility and leases the remaining 9,500 square feet to others.

The Company leases a warehouse and distribution facility in Eden Prairie of approximately 150,000 square feet. The current lease for this facility expires on March 31, 2001. The Company also leases a warehouse and distribution facility in Bloomington, Minnesota of approximately 159,000 square feet, the lease for which expires on February 28, 1999 and is extendible at the Company's option for an additional three years. Nearby the Bloomington distribution facility is additional bulk storage warehouse space of approximately 52,000 square feet, the Company's lease for which expires on February 28, 1999 and is extendible at the Company's option for an additional three years. The Company believes that its current facilities are adequate to support its needs and presently anticipated growth. However, the Company continuously evaluates its need for additional facilities. The Company also leases a corporate showroom of approximately 10,200 square feet in the Atlanta, Georgia gift mart and a corporate showroom of approximately 7,500 square feet in the Chicago, Illinois gift mart. These leases expire on December 31, 2006 and November 30, 1999, respectively.

#### **Item 3. 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 of the Company.

#### **Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matters were submitted to a vote of the Company's security holders during the last quarter of the year ended December 30, 1995.

#### **Additional Item. EXECUTIVE OFFICERS OF THE REGISTRANT**

Set forth below are the executive officers of the Company as of the date hereof. In connection with the Initial Public Offering, each person then an executive officer of D 56, Inc. was appointed on

April 22, 1993 to serve as an executive officer of the Company. Unless otherwise indicated each executive officer of D 56, Inc. holds identical positions with the Company as he or she does with D 56, Inc. Officers serve at the discretion of the Board of Directors.

Name	Age	Position(s) with the Company
Edward R. Bazinet	52	Chairman of the Board and Chief Executive Officer
Susan E. Engel	49	President and Chief Operating Officer
Mark R. Kennedy	38	Chief Financial Officer and Vice President — Administration
David H. Weiser	36	Vice President, General Counsel and Secretary
David W. Dewey	38	Vice President — Overseas Operations
William E. Kirchner	48	Vice President — Product Development and Advertising
Sing F. Lo	51	Vice President — Management Information Systems
Bruce A. Maurer	49	Vice President — Sales
Robert S. Rose	41	Vice President — Distribution and Operations
Timothy J. Schugel	37	Vice President — Finance and Principal Accounting Officer
Joan M. Serena	42	Vice President — Consumer & Retail Marketing

The principal occupations and positions for the past five years, and in certain cases prior years, of each of the executive officers of the Company are as follows:

Edward R. Bazinet has been Chairman of the Board and Chief Executive Officer of the Company and of D 56, Inc. since April 22, 1993. Mr. Bazinet was the founder of D 56, Inc. and was President of D 56, Inc. from 1984 until April 22, 1993.

Susan E. Engel has been President and Chief Operating Officer of the Company and of D 56, Inc. since September 19, 1994. Ms. Engel was a consultant to retail and consumer goods companies from September 1993 until September 1994, and Chief Executive Officer and President of Champion Products, Inc. from October 1991 to September 1993. Prior to October 1991, Ms. Engel served 14 years at Booz-Allen and Hamilton, the management consulting firm, most recently as Partner-in-Charge of the U.S. Eastern region retailing practice.

Mark R. Kennedy has been Chief Financial Officer and Vice President — Administration of the Company and of D 56, Inc. since April 25, 1995. Mr. Kennedy was Senior Executive Vice President of Shopko Stores, Inc. from June 1993 to January 1995, and its Senior Vice President and Chief Financial Officer from February 1992 to June 1993. He was Senior Vice President and Treasurer of Federated Department Stores, Inc. and Allied Stores Corporation from January 1990 to February 1992.

David H. Weiser has been Vice President and General Counsel of the Company since April 22, 1993 and Secretary of the Company and of D 56, Inc. since February 1993. Mr. Weiser has been Vice President and General Counsel of D 56, Inc. since March 15, 1993. He was an associate in the law firm of Fried, Frank, Harris, Shriver & Jacobson from 1986 until March 15, 1993.

David W. Dewey has been Vice President — Overseas Operations of the Company and of D 56, Inc. since April 22, 1993. Mr. Dewey was Vice President of Marketing of D 56, Inc. from March 1990 until April 22, 1993.

William E. Kirchner has been Vice President — Product Development and Advertising of the Company and of D 56, Inc. since April 22, 1993. Mr. Kirchner was Director of Advertising and New Product Development of D 56, Inc. from May 1984 until April 22, 1993.

Sing F. Lo has been Vice President — Management Information Systems of the Company and of D 56, Inc. since June 6, 1994. Mr. Lo was Director — Management Information Systems of D 56, Inc. from September 1989 until June 6, 1994.

Bruce A. Maurer has been Vice President — Sales of the Company and of D 56, Inc. since November 7, 1995. Mr. Maurer was Vice President of Sales of Fitz and Floyd/Omnibus from November 1993 to November 1995, and Vice President of Sales of M. W. Carr and Co. from January 1993 to November 1993. He was Divisional Vice President of Sales of Pfaltzgraff Company from September 1992 to December 1992, and its National Sales Manager from July 1990 to September 1992.

Robert S. Rose has been Vice President — Distribution and Operations of the Company and of D 56, Inc. since April 22, 1993. Mr. Rose was Vice President of Operations of D 56, Inc. from September 1988 until April 22, 1993.

Timothy J. Schugel has been Vice President — Finance of the Company and of D56, Inc. since April 10, 1995, and was Controller of the Company and of D 56, Inc. from April 26, 1993 until April 10, 1995. He was a Senior Manager/Manager with the public accounting firm of Deloitte & Touche from 1986 until April 24, 1993.

Joan M. Serena has been Vice President — Consumer & Retail Marketing since October [20], 1995. She was Vice President — Consumer Services of the Company and of D 56, Inc. from April 22, 1993 until October 20, 1995. Ms. Serena was Vice President, Sales Services of D 56, Inc. from June 1992 until April 22, 1993. Ms. Serena was Divisional Product Merchandising Manager of the Home Furnishing Division of Associated Merchandising Corporation from August 1988 through May 1992.

## PART II

### **Item 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS**

Information required by this Item is included in Corporate and Stockholder Information on page 28 of the 1995 Annual Report and Note 7 to Five Year Summary on page 10 of the 1995 Annual Report, and such information is incorporated herein by reference.

As of March 20, 1996, the number of holders of record of the Company's Common Stock was 974.

### **Item 6. SELECTED FINANCIAL DATA**

Information required by this Item is included in Five Year Summary on page 10 of the 1995 Annual Report, and such information is incorporated herein by reference. See also the notes to the consolidated financial statements and Management's Discussion and Analysis on pages 21 to 26 and 11 to 15, respectively, of the 1995 Annual Report, and such information is incorporated herein by reference.

### **Item 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Information required by this Item is included in Management's Discussion and Analysis on pages 11 to 15 of the 1995 Annual Report, incorporated herein by reference.

### **Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Information required by this Item is included in the consolidated financial statements of the Company for the years ended December 30, 1995, December 31, 1994 and January 1, 1994, the notes to the consolidated financial statements, and the report of independent auditors thereon on pages 17 to 27 of the 1995 Annual Report, and in the Company's unaudited quarterly financial data for the years ended December 30, 1995 and December 31, 1994 on page 13 of the 1995 Annual Report, incorporated herein by reference.

### **Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None in 1995.

## **PART III**

### **Item 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

Information required by this Item concerning directors of the Company is included in the 1996 Proxy Statement in the section captioned "Item 1 — Election of Directors," and such information is incorporated herein by reference. Information required by this Item concerning the executive officers of the Company is included in Part I, pages 7 through 9 of this Annual Report on Form 10-K as permitted by General Instruction G(3) to Form 10-K. Information required by this Item concerning compliance with Section 16(a) of the Securities Exchange Act of 1934 is included in the 1996 Proxy Statement in the last paragraph of the section captioned "Security Ownership of Certain Beneficial Owners and Management," and such information is incorporated herein by reference. Theodore J. Forstmann and Nicholas C. Forstmann, both of whom are directors of the Company, are brothers.

### **Item 11. EXECUTIVE COMPENSATION**

Information required by this Item is included in the 1996 Proxy Statement in the section captioned "Further Information Concerning the Board of the Directors and Committees — Compensation Committee Interlocks and Insider Participation" and "— Director Compensation" and in the section captioned "Compensation of Executive Officers" (other than the subsection thereof captioned "Compensation Committee Report on Executive Compensation" and "Performance Graph"), and such information (other than the subsections thereof captioned "Compensation Committee Report on Executive Compensation" and "Performance Graph") is incorporated herein by reference.

### **Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT**

Information required by this Item is included in the 1996 Proxy Statement in the section captioned "Security Ownership of Certain Beneficial Owners and Management", and such information is incorporated herein by reference.

### **Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

Information required by this Item is included in the 1996 Proxy Statement in the section captioned "Certain Related Party Transactions," and such information is incorporated herein by reference. See also, Note 9 to the consolidated financial statements on page 25 of the 1995 Annual Report.

## PART IV

### Item 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

	<b>1995</b>	
	<b>Form 10-K (Page)</b>	<b>Annual Report (Page)</b>
<b>(a) 1. Financial Statements</b>		
Consolidated Balance Sheets at December 30, 1995 and December 31, 1994		17
For the years ended December 30, 1995, December 31, 1994 and January 1, 1994:		
Consolidated Statements of Income		18
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Independent Auditors' Report for the years ended December 30, 1995, December 31, 1994 and January 1, 1994		27
<b>2. Financial Statement Schedules</b>		
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II. Valuation and qualifying accounts		17

All other schedules have been omitted because they are not applicable, not required or the information required is included in the consolidated financial statements or notes thereto.

### 3. Exhibits

The exhibits are listed in the accompanying Index to Exhibits on pages 20 and 21.

### (b) Reports on Form 8-K

None.

## 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 30, 1995 and December 31, 1994 and the related consolidated statements of income, cash flows and stockholders' equity for the years ended December 30, 1995, December 31, 1994 and January 1, 1994, and have issued our report thereon dated February 14, 1996 (included in the Company's Annual Report to Stockholders for the year ended December 30, 1995 and incorporated herein by reference). Our audits also included the financial statement schedules for the aforementioned periods listed in Item 14 of Form 10-K. These financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statement schedules based on our audits. In our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

*Deloitte & Touche LLP*

Deloitte & Touche LLP  
Minneapolis, Minnesota  
February 14, 1996

**DEPARTMENT 56, INC.**  
**(Parent company only)**

**SCHEDULE I — CONDENSED FINANCIAL INFORMATION**  
**BALANCE SHEETS**  
(In thousands)

	<u>December 30, 1995</u>	<u>December 31, 1994</u>
<b>ASSETS</b>		
INVESTMENT IN SUBSIDIARY .....	\$148,993	\$208,461
RECEIVABLE FROM SUBSIDIARY .....	1,563	1,342
	<u>\$150,556</u>	<u>\$209,803</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Current portion of long-term debt .....	\$ —	\$ 20,000
Accrued stock issuance costs .....	270	854
Accrued interest payable .....	—	644
	<u>270</u>	<u>21,498</u>
LONG-TERM DEBT, NET OF CURRENT PORTION .....	—	88,000
<b>STOCKHOLDERS' EQUITY:</b>		
Preferred stock, \$.01 par value; authorized 20,000 shares; no shares issued .....	—	—
Common Stock, \$.01 par value; authorized 100,000 shares; issued and outstanding 21,546 and 21,475 shares, respectively .....	215	215
Additional paid-in capital .....	41,803	40,244
Unearned compensation on common stock options .....	(14)	(183)
Retained earnings .....	<u>108,282</u>	<u>60,029</u>
Total stockholders' equity .....	<u>150,286</u>	<u>100,305</u>
	<u><u>\$150,556</u></u>	<u><u>\$209,803</u></u>

Note: Investment in subsidiary is accounted for under the equity method of accounting.

See notes to consolidated financial statements included in the  
1995 Annual Report, incorporated by reference.

**DEPARTMENT 56, INC.**  
**(Parent company only)**

**SCHEDULE I — CONDENSED FINANCIAL INFORMATION (Continued)**  
**STATEMENTS OF INCOME**  
**(In thousands)**

	<u>Year Ended December 30, 1995</u>	<u>Year Ended December 31, 1994</u>	<u>Year Ended January 1, 1994</u>
Equity in earnings of subsidiary .....	\$49,435	\$46,740	\$39,959
Interest expense .....	(955)	(10,376)	(14,930)
General and administrative expenses .....	(227)	(265)	(32)
Income before income taxes .....	48,253	36,099	24,997
Income taxes .....	—	—	—
Net income .....	<u>\$48,253</u>	<u>\$36,099</u>	<u>\$24,997</u>

See notes to consolidated financial statements included in the  
1995 Annual Report, incorporated by reference.

**DEPARTMENT 56, INC.**  
**(Parent company only)**

**SCHEDULE I — CONDENSED FINANCIAL INFORMATION (Continued)**  
**STATEMENTS OF CASH FLOWS**  
(In thousands)

	<u>Year Ended December 30, 1995</u>	<u>Year Ended December 31, 1994</u>	<u>Year Ended January 1, 1994</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income .....	\$ 48,253	\$ 36,099	\$ 24,997
Adjustments to reconcile net income to net cash provided by operating activities:			
Dividends received from subsidiaries .....	109,596	51,455	82,194
Equity in earnings of subsidiaries .....	(49,435)	(46,740)	(39,959)
Decrease in accrued interest payable .....	(644)	(226)	(2,284)
(Decrease) increase in payable to subsidiaries .....	—	(862)	862
(Increase) decrease in receivable from subsidiaries .....	(51)	(15)	1,167
Payment of stock issuance costs .....	(584)	(752)	(2,094)
Net cash provided by operating activities .....	<u>58,882</u>	<u>38,959</u>	<u>64,883</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from the exercise of stock options .....	865	1,041	117
Principal payments on long-term debt .....	(108,000)	(40,000)	(65,000)
Net cash used in financing activities .....	<u>(107,135)</u>	<u>(38,959)</u>	<u>(64,883)</u>
<b>NET CHANGE IN CASH AND CASH EQUIVALENTS .....</b>			
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD .....</b>			
CASH AND CASH EQUIVALENTS AT END OF PERIOD ..	<u>\$ —</u>	<u>\$ —</u>	<u>\$ —</u>

See notes to consolidated financial statements included in the  
1995 Annual Report, incorporated by reference.

**DEPARTMENT 56, INC.**  
**SCHEDULE II — VALUATION AND QUALIFYING ACCOUNTS**  
(In thousands)

Description	Column A Balance at Beginning of Period	Column B (1)Charged to Costs and Expenses	Column C — Additions (2)Charged to Other Accounts	Column D Deductions	Column E Balance at End of Period
<b>Year ended December 30, 1995:</b>					
Allowance for doubtful accounts receivable .....	\$3,592	\$ 2,293	—	\$1,556(a)	\$ 4,329
Allowance for obsolete and overstock inventory .....	2,660	1,866	—	922	3,604
Allowance for sales returns and credits ..	1,641	6,529	—	5,615	2,555
	<u>\$7,893</u>	<u>\$10,688</u>	<u>—</u>	<u>\$8,093</u>	<u>\$10,488</u>
<b>Year ended December 31, 1994:</b>					
Allowance for doubtful accounts receivable .....	\$3,314	\$ 1,107	—	\$ 829(a)	\$ 3,592
Allowance for obsolete and overstock inventory .....	2,413	539	—	292	2,660
Allowance for sales returns and credits ..	1,470	4,593	—	4,422	1,641
	<u>\$7,197</u>	<u>\$ 6,239</u>	<u>—</u>	<u>\$5,543</u>	<u>\$ 7,893</u>
<b>Year ended January 1, 1994:</b>					
Allowance for doubtful accounts receivable .....	\$2,433	\$ 1,922	—	\$1,041(a)	\$ 3,314
Allowance for obsolete and overstock inventory .....	1,575	1,680	—	842	2,413
Allowance for sales returns and credits ..	921	3,142	\$307(b)	2,900	1,470
	<u>\$4,929</u>	<u>\$ 6,744</u>	<u>\$307</u>	<u>\$4,783</u>	<u>\$ 7,197</u>

- (a) Accounts determined to be uncollectible and charged against allowance account, net of collections on accounts previously charged against allowance account.
- (b) Adjustment in reserve for the estimated amount of resaleable inventory to be returned in the future.

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Department 56, Inc.

By:   
Edward R. Bazinet  
Chairman of the Board  
and Chief Executive Officer

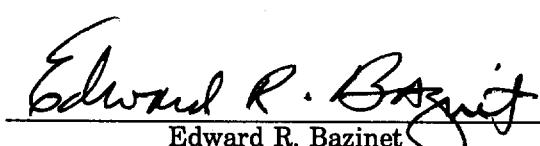
Date: March 28 1996

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

### Signature

### Capacity in which signed

### Date

  
Edward R. Bazinet

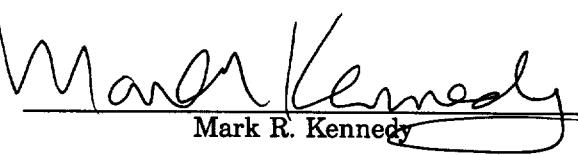
Chairman of the Board,  
Chief Executive Officer  
and Director  
(Principal Executive Officer)

March 28 , 1996

Susan E. Engel

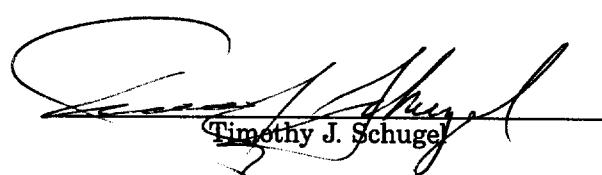
President and  
Chief Operating Officer  
and Director

, 1996

  
Mark R. Kennedy

Chief Financial Officer and  
Vice President —  
Administration  
(Principal Financial Officer)

March 28 , 1996

  
Timothy J. Schugel

Vice President — Finance and  
Principal Accounting Officer  
(Principal Accounting Officer)

March 28 , 1996

Todd L. Bachman

Director

, 1996

Nicholas C. Forstmann

Director

, 1996

Theodore J. Forstmann

Director

, 1996

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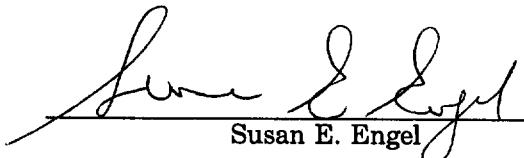
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*Chairman of the Board  
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Date: , 1996

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 Susan E. Engel	President and Chief Operating Officer and Director	March 28, 1996
Mark R. Kennedy	Chief Financial Officer and Vice President — Administration (Principal Financial Officer)	, 1996
Timothy J. Schugel	Vice President — Finance and Principal Accounting Officer (Principal Accounting Officer)	, 1996
Todd L. Bachman	Director	, 1996
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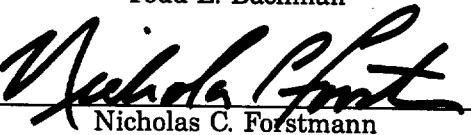
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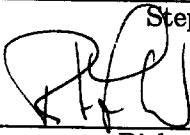
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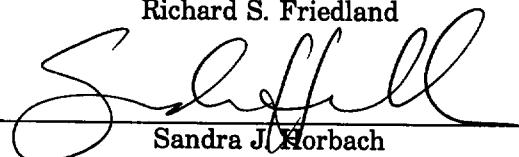
Date: , 1996

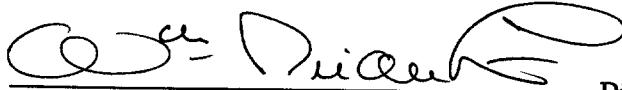
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 Stephen Fraidin	Director	March 28 , 1996
Richard S. Friedland	Director	, 1996
Sandra J. Horbach	Director	, 1996
Wm. Brian Little	Director	, 1996
Steven G. Rothmeier	Director	, 1996
Arthur T. Shorin	Director	, 1996
Vin Weber	Director	, 1996

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Vin Weber	Director	, 1996

SignatureCapacity in which signedDate

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Stephen Fraidin

Director

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Richard S. Friedland

Director

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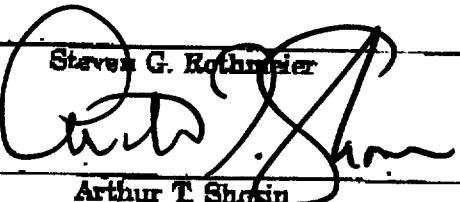
Sandra J. Horbach

Director

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Wm. Brian Little

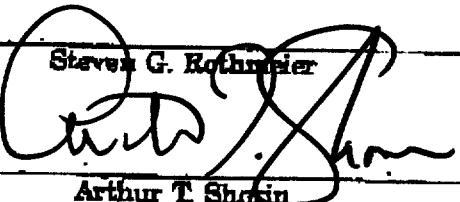
Director



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Steven G. Rothman

Director



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Arthur T. Shokin

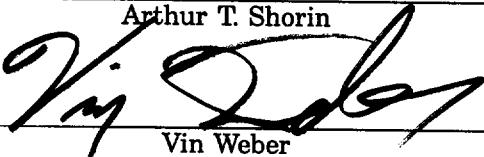
Director

March 28, 1996

---

Vir Weber

Director

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Richard S. Friedland	Director	, 1996
Sandra J. Horbach	Director	, 1996
Wm. Brian Little	Director	, 1996
Steven G. Rothmeier	Director	, 1996
Arthur T. Shorin  Vin Weber	Director	, 1996
	Director	March 28, 1996

**DEPARTMENT 56, INC.**  
**INDEX TO EXHIBITS**

<u>Exhibit</u>	<u>Description</u>	<u>Page</u>
2.1	Agreement of Purchase and Sale, dated as of October 6, 1992, by and among the Company, Bachman's Holdings, Inc., ed bazinet international, inc., Edward R. Bazinet and certain other individuals (the Company agrees to furnish to the Commission, upon request, on a supplemental basis, a copy of any omitted exhibit). (Incorporated herein by reference to Exhibit 2.1 of Registrant's Registration Statement on Form S-1, No. 33-61514.)	—
3.1	Restated Certificate of Incorporation of the Company. (Incorporated herein by reference to Exhibit 3.1 of Registrant's Quarterly Report on Form 10-Q for the quarter ended July 3, 1993.)	—
3.2	Restated By-Laws of the Company. (Incorporated herein by reference to Exhibit 3.2 of Registrant's Registration Statement on Form S-1, No. 33-61514 and to Exhibits 1 and 2 of Registrant's Current Report on Form 8-K dated February 15, 1996.)	—
4.1	Specimen form of Company's Common Stock certificate. (Incorporated herein by reference to Exhibit 4.1 of Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 1994.)	—
10.1	Department 56, Inc. 1992 Stock Option Plan. (Incorporated herein by reference to Exhibit 10.1 of Registrant's Registration Statement on Form S-1, No. 33-61514.)†	—
10.2	Form of Stock Option Agreement in connection with the 1992 Stock Option Plan. (Incorporated herein by reference to Exhibit 10.2 of Registrant's Registration Statement on Form S-1, No. 33-61514.)†	—
10.3	Form of Outside Directors Stock Option Agreement. (Incorporated herein by reference to Exhibit 10.4 of Registrant's Annual Report on Form 10-K for the fiscal year ended January 1, 1994.)†	—
10.4	Lease, dated April 1, 1989, as amended, between Hoyt Properties, Inc. and the Company for the Eden Prairie warehouse. (Incorporated herein by reference to Exhibit 10.7 of Registrant's Registration Statement on Form S-1, No. 33-61514.)	—
10.5	Lease, dated December 8, 1993 as amended August 25, 1994, between Grantor Retained Income Trust of Robert L. Johnson and the Company for the Bloomington warehouse. (Incorporated herein by reference to Exhibit 10.5 of Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 1994.)	—
10.6	Amended and Restated Credit Agreement, dated as of February 17, 1995, among D 56, Inc., the Banks parties thereto, and Chemical Bank as agent, issuing bank and accepting bank. (Incorporated herein by reference to Exhibit 10.1 of Registrant's Current Report on Form 8-K dated February 17, 1995.)	—
10.7	Pledge Agreement, dated as of February 17, 1995, by the Company in favor of Chemical Bank. (Incorporated herein by reference to Exhibit 10.2 of Registrant's Current Report on Form 8-K dated February 17, 1995.)	—
10.8	Guarantee, dated as of February 17, 1995, by the Company in favor of Chemical Bank. (Incorporated herein by reference to Exhibit 10.3 of Registrant's Current Report on Form 8-K dated February 17, 1995.)	—
10.9	Pledge Agreement, dated as of February 17, 1995, by D 56, Inc. in favor of Chemical Bank. (Incorporated herein by reference to Exhibit 10.8 of Registrant's Current Report on Form 8-K dated February 17, 1995.)	—
10.10	Pledge Agreement, dated as of February 17, 1995, by FL 56 Intermediate Corp. in favor of Chemical Bank. (Incorporated herein by reference to Exhibit 10.4 of Registrant's Current Report on Form 8-K dated February 17, 1995.)	—

<u>Exhibit</u>	<u>Description</u>	
10.11	Guarantee, dated as of February 17, 1995, by FL 56 Intermediate Corp. in favor of Chemical Bank. (Incorporated herein by reference to Exhibit 10.5 of Registrant's Current Report on Form 8-K dated February 17, 1995.)	
10.12	Pledge Agreement, dated as of February 17, 1995, by ed bazinet international, inc. in favor of Chemical Bank. (Incorporated herein by reference to Exhibit 10.6 of Registrant's Current Report on Form 8-K dated February 17, 1995.)	
10.13	Guarantee, dated as of February 17, 1995, by ed bazinet international, inc. in favor of Chemical Bank. (Incorporated herein by reference to Exhibit 10.7 of Registrant's Current Report on Form 8-K dated February 17, 1995.)	
10.14	Guarantee, dated as of February 17, 1995, by Department 56 Trading Co., Ltd. in favor of Chemical Bank. (Incorporated herein by reference to Exhibit 10.9 of Registrant's Current Report on Form 8-K dated February 17, 1995.)	
10.15	Registration Rights Agreement between the Company, Department 56 Partners, L.P. and Forstmann Little & Co. Subordinated Debt and Equity Management Buyout Partnership-IV. (Incorporated herein by reference to Exhibit 10.23 of Registrant's Registration Statement on Form S-1, No. 33-61514.)	
10.16	Form of Indemnification Agreement between the Company and its directors and executive officers. (Incorporated herein by reference to Exhibit 10.24 of Registrant's Registration Statement on Form S-1, No. 33-61514.)	
10.17	Department 56, Inc. 1993 Stock Incentive Plan. (Incorporated herein by reference to Exhibit 10.25 of Registrant's Registration Statement on Form S-1, No. 33-61514.)†	
10.18	Department 56, Inc. 1995 Stock Incentive Plan.†*	32
10.19	Form of Stock Option Agreement in connection with Department 56, Inc. 1993 Stock Incentive Plan and Department 56, Inc. 1995 Stock Incentive Plan. (Incorporated herein by reference to Exhibit 10.1 of Registrant's Quarterly Report on Form 10-Q for the quarter ended July 3, 1993.)†	
10.20	Aircraft Lease, dated as of April 15, 1994, between Fleet Credit Corporation, as Lessor, and D 56, Inc., as Lessee. (Incorporated herein by reference to Exhibit 10.27 of Registrant's Registration Statement on Form S-1, No. 33-77278.)	
10.21	Aircraft Management Agreement, dated February 10, 1994, between Department 56 Trading Co., Ltd. (subsequently assigned to D 56, Inc.) and Lear Siegler Management Corp. (Incorporated herein by reference to Exhibit 10.25 of Registrant's Annual Report on Form 10-K for the fiscal year ended January 1, 1994.)	
10.22	Time Sharing Agreement, dated February 10, 1994, between Department 56 Trading Co., Ltd. (subsequently assigned to D 56, Inc.) and Edward R. Bazinet. (Incorporated herein by reference to Exhibit 10.26 of Registrant's Annual Report on Form 10-K for the fiscal year ended January 1, 1994.)	
11.1	Computation of Earnings Per Share.*	66
13.1	Annual Report to Stockholders for fiscal year ended December 30, 1995. (The 1995 Annual Report, except for those portions thereof which are expressly incorporated by reference in this Annual Report on Form 10-K, is being furnished for the Information of the Commission and is not to be deemed "filed" as part of the Form 10-K.)*	68
21.1	Subsidiaries of the Company.*	101
23.1	Consent of Deloitte & Touche LLP*	103

† Management contract or compensatory plan  
 \* Filed herewith

**EXHIBIT 10.18**

**DEPARTMENT 56, INC.**

**1995 STOCK INCENTIVE PLAN**  
**(As Adopted May 18, 1995)**

**DEPARTMENT 56, INC.  
1995 STOCK INCENTIVE PLAN  
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**DEPARTMENT 56, INC.  
1995 STOCK INCENTIVE PLAN**

**1. Purpose.**

The purpose of this Plan is to strengthen Department 56, Inc., a Delaware corporation (the "Company"), by providing an incentive to its officers, employees, consultants, directors and advisors and thereby encouraging them to devote their abilities and industry to the success of the Company's business enterprise. It is intended that this purpose be achieved by extending to officers, employees, consultants and directors of the Company and its subsidiaries an added long-term incentive for high levels of performance and unusual efforts through the grant of Incentive Stock Options, Nonqualified Stock Options, Stock Appreciation Rights, Restricted Stock, Performance Units, Performance Shares and Dividend Equivalent Rights (as each term is hereinafter defined).

**2. Definitions.**

For purposes of the Plan:

2.1 "Adjusted Fair Market Value" means, in the event of a Change in Control, the greater of (i) the highest price per Share paid to holders of the Shares in any transaction (or series of transactions) constituting or resulting in a Change in Control or (ii) the highest Fair Market Value of a Share during the ninety (90) day period ending on the date of a Change in Control.

2.2 "Agreement" means the written agreement between the Company and an Optionee or Grantee evidencing the grant of an Option or Award and setting forth the terms and conditions thereof.

2.3 "Award" means a grant of Restricted Stock, a Stock Appreciation Right, a Performance Award, a Dividend Equivalent Right or any or all of them.

2.4 "Board" means the Board of Directors of the Company.

2.5 "Cause" means the commission of an act of fraud or intentional misrepresentation or an act of embezzlement, misappropriation or conversion of assets or opportunities of the Company or any Subsidiary.

2.6 "Change in Capitalization" means any increase or reduction in the number of Shares, or any change (including, but not limited to, a change in value) in the Shares or exchange of Shares for a different number or kind of shares or other

securities of the Company, by reason of a reclassification, recapitalization, merger, consolidation, reorganization, spin-off, split-up, issuance of warrants or rights or debentures, stock dividend, stock split or reverse stock split, cash dividend, property dividend, combination or exchange of shares, repurchase of shares, change in corporate structure or otherwise.

2.7 A "Change in Control" shall mean the occurrence during the term of the Plan of:

- (a) An acquisition (other than directly from the Company) of any voting securities of the Company (the "Voting Securities") by any 'Person' (as the term person is used for purposes of Section 13(d) or 14(d) of the Exchange Act), other than Department 56 Partners, L.P. or Forstmann Little & Co. Subordinated Debt and Equity Management Buyout Partnership IV or any of their affiliates (individually or in the aggregate), immediately after which such Person has 'Beneficial Ownership' (within the meaning of Rule 13d-3 promulgated under the Exchange Act) of fifty-one percent (51%) or more of the combined voting power of the Company's then outstanding Voting Securities; provided, however, in determining whether a Change in Control has occurred, Voting Securities which are acquired in a 'Non-Control Acquisition' (as hereinafter defined) shall not constitute an acquisition which would cause a Change in Control. A 'Non-Control Acquisition' shall mean an acquisition by (i) an employee benefit plan (or a trust forming a part thereof) maintained by (A) the Company or (B) any corporation or other Person of which a majority of its voting power or its voting equity securities or equity interest is owned, directly or indirectly, by the Company (for purposes of this definition, a 'Subsidiary'), (ii) the Company or its Subsidiaries, or (iii) any Person in connection with a 'Non-Control Transaction' (as hereinafter defined);
- (b) The individuals who, as of June 1, 1993, are members of the Board (the "Incumbent Board"), cease for any reason to constitute at least two-thirds of the members of the Board; provided, however, that if the election, or nomination for election by the Company's common stockholders, of any new director was approved by a vote of at least two-thirds of the Incumbent Board, such new director shall, for purposes of this Plan, be considered as a member of the Incumbent Board; provided further, however, that no individual shall be considered a member of the Incumbent Board if such individual initially assumed office as a result of either an actual or threatened 'Election Contest' (as described in Rule 14a-11 promulgated under the Exchange Act) or other actual or threatened solicitation of proxies or consents by or on behalf of a Person other than the Board (a "Proxy Contest") including by reason of any agreement intended to avoid or settle any Election Contest or Proxy Contest; or

(c) Approval by stockholders of the Company of:

- (i) A merger, consolidation or reorganization involving the Company, unless (A) the stockholders of the Company, immediately before such merger, consolidation or reorganization, own, directly or indirectly immediately following such merger, consolidation or reorganization, at least sixty percent (60%) of the combined voting power of the outstanding voting securities of the corporation resulting from such merger or consolidation or reorganization (the "Surviving Corporation") in substantially the same proportion as their ownership of the Voting Securities immediately before such merger, consolidation or reorganization, (B) the individuals who were members of the Incumbent Board immediately prior to the execution of the agreement providing for such merger, consolidation or reorganization constitute at least two-thirds of the members of the board of directors of the Surviving Corporation, or a corporation beneficially owing a majority of the Voting Securities of the Surviving Corporation, (C) no Person other than the Company, any Subsidiary, any employee benefit plan (or any trust forming a part thereof) maintained by the Company, the Surviving Corporation, or any Subsidiary, or any Person who, immediately prior to such merger, consolidation or reorganization had Beneficial Ownership of fifty-one percent (51%) or more of the then outstanding Voting Securities owns, directly or indirectly fifty-one percent (51%) or more of the combined voting power of the Surviving Corporation's then outstanding voting securities, and (D) a transaction described in clauses (A) through (C) shall herein be referred to as a 'Non-Control Transaction';
- (ii) A complete liquidation or dissolution of the Company; or
- (iii) An agreement for the sale or other disposition of all or substantially all of the assets of the Company to any Person (other than a transfer to a Subsidiary).

Notwithstanding the foregoing, a Change in Control shall not be deemed to occur solely because any Person (the "Subject Person") acquired Beneficial Ownership of more than the permitted amount of the outstanding Voting Securities as a result of the acquisition of Voting Securities by the Company which, by reducing the number of Voting Securities outstanding, increases the proportional number of shares Beneficially Owned by the Subject Persons, provided that if a Change in Control would occur (but for the operation of this sentence) as a result of the acquisition of Voting Securities by the Company, and after such share acquisition by the Company, the

Subject Person becomes the Beneficial Owner of any additional Voting Securities which increases the percentage of the then outstanding Voting Securities Beneficially Owned by the Subject Person, then a Change in Control shall occur.

- 2.8 "Code" means the Internal Revenue Code of 1986, as amended.
- 2.9 "Committee" means a committee consisting of at least two (2) persons appointed by the Board to administer the Plan and to perform the functions set forth herein, all of whom are Disinterested Directors and Outside Directors.
- 2.10 "Company" means Department 56, Inc.
- 2.11 "Director Option" means an Option granted pursuant to Section 6.
- 2.12 "Disability" means a physical or mental infirmity which impairs the Optionee's ability to perform substantially his or her duties for a period of one hundred eighty (180) consecutive days.
- 2.13 "Disinterested Director" means a director of the Company who is "disinterested" within the meaning of Rule 16b-3 under the Exchange Act.
- 2.14 "Dividend Equivalent Right" means a right to receive all or some portion of the cash dividends that are or would be payable with respect to Shares.
- 2.15 "Division" means any of the operating units or divisions of the Company designated as a Division by the Committee.
- 2.16 "Eligible Individual" means any officer, employee, consultant or advisor of the Company or a Subsidiary designated by the Committee as eligible to receive Options or Awards subject to the conditions set forth herein.
- 2.17 "Employee Option" means an Option granted pursuant to Section 5.
- 2.18 "Exchange Act" means the Securities Exchange Act of 1934, as amended.
- 2.19 "Fair Market Value" on any date means the average of the high and low sales prices of the Shares on such date on the principal national securities exchange on which such Shares are listed or admitted to trading, or if such Shares are not so listed or admitted to trading, the arithmetic mean of the per Share closing bid price and per Share closing asked price on such date as quoted on the National Association of Securities Dealers Automated Quotation System or such other market in which such prices are regularly quoted, or, if there have been no published bid or asked quotations with respect to Shares on such date, the Fair

Market Value shall be the value established by the Board in good faith and, in the case of an Incentive Stock Option, in accordance with Section 422 of the Code.

2.20 "Grantee" means a person to whom an Award has been granted under the Plan.

2.21 "Incentive Stock Option" means an Option satisfying the requirements of Section 422 of the Code and designated by the Committee as an Incentive Stock Option.

2.22 "Nonemployee Director" means a director of the Company who is not an employee of the Company or any Subsidiary.

2.23 "Nonqualified Stock Option" means an Option which is not an Incentive Stock Option.

2.24 "Option" means an Employee Option, a Director Option, or either or both of them.

2.25 "Optionee" means a person to whom an Option has been granted under the Plan.

2.26 "Outside Director" means a director of the Company who is an "outside director" within the meaning of Section 162(m) of the Code and the regulations promulgated thereunder.

2.27 "Parent" means any corporation which is a parent corporation (within the meaning of Section 424(e) of the Code) with respect to the Company.

2.28 "Performance Awards" means Performance Units, Performance Shares or either or both of them.

2.29 "Performance Cycle" means the time period specified by the Committee at the time a Performance Award is granted during which the performance of the Company, a Subsidiary or a Division will be measured.

2.30 "Performance Objectives" has the meaning set forth in Section 10.1.

2.31 "Performance Shares" means Shares issued or transferred to an Eligible Individual under Section 10.3.

2.32 "Performance Unit" means Performance Units granted to an Eligible Individual under Section 10.2.

2.33 "Plan" means the Department 56, Inc. 1995 Stock Incentive Plan.

2.34 "Pooling Transaction" means an acquisition of or by the Company in a transaction which is intended to be treated as a "pooling of interests" under generally accepted accounting principles.

2.35 "Restricted Stock" means Shares issued or transferred to an Eligible Individual pursuant to Section 9.

2.36 "Shares" means the common stock, par value \$.01 per share, of the Company.

2.37 "Stock Appreciation Right" means a right to receive all or some portion of the increase in the value of the Shares as provided in Section 8 hereof.

2.38 "Stockholders Agreement" means a stockholders agreement governing the rights, duties and obligations of present or future employees or directors, as the case may be, of the Company or its Subsidiaries with respect to Shares granted or sold to such persons, or issued pursuant to options or other awards granted to such persons, in such form as is in use by the Company at the time of exercise of an Option or any part thereof or the issuance of Shares pursuant to an Award and which the Company elects to require an Optionee or Grantee to execute in connection with the issuance of Shares.

2.39 "Subsidiary" means any corporation which is a subsidiary corporation (within the meaning of Section 424(f) of the Code) with respect to the Company.

2.40 "Successor Corporation" means a corporation, or a parent or subsidiary thereof within the meaning of Section 424(a) of the Code, which issues or assumes a stock option in a transaction to which Section 424(a) of the Code applies.

2.41 "Ten-Percent Stockholder" means an Eligible Individual, who, at the time an Incentive Stock Option is to be granted to him or her, owns (within the meaning of Section 422(b)(6) of the Code) stock possessing more than ten percent (10%) of the total combined voting power of all classes of stock of the Company, or of a Parent or a Subsidiary.

**3. Administration.**

**3.1** The Plan shall be administered by the Committee which shall hold meetings at such times as may be necessary for the proper administration of the Plan. The Committee shall keep minutes of its meetings. A quorum shall consist of not less than two members of the Committee and a majority of a quorum may authorize any action. Any decision or determination reduced to writing and signed by a majority of all of the members shall be as fully effective as if made by a majority vote at a meeting duly called and held. Each member of the Committee shall be a Disinterested Director. No member of the Committee shall be liable for any action, failure to act, determination or interpretation made in good faith with respect to this Plan or any transaction hereunder, except for liability arising from his or her own willful misfeasance, gross negligence or reckless disregard of his or her duties. The Company hereby agrees to indemnify each member of the Committee for all costs and expenses and, to the extent permitted by applicable law, any liability incurred in connection with defending against, responding to, negotiation for the settlement of or otherwise dealing with any claim, cause of action or dispute of any kind arising in connection with any actions in administering this Plan or in authorizing or denying authorization to any transaction hereunder.

**3.2** Subject to the express terms and conditions set forth herein, the Committee shall have the power from time to time to:

- (a) determine those individuals to whom Options shall be granted under the Plan and the number of Incentive Stock Options and/or Nonqualified Stock Options to be granted to each Eligible Individual or Nonemployee Director and to prescribe the terms and conditions (which need not be identical) of each Option, including the purchase price per Share subject to each Option, and make any amendment or modification to any Agreement consistent with the terms of the Plan; and
- (b) select those Eligible Individuals to whom Awards shall be granted under the Plan and to determine the number of Stock Appreciation Rights, Performance Units, Performance Shares, and/or Shares of Restricted Stock to be granted pursuant to each Award, the terms and conditions of each Award, including the restrictions or Performance Objectives relating to such Units or Shares, the maximum value of each Performance Unit and Performance Share and make any amendment or modification to any Agreement consistent with the terms of the Plan.

**3.3** Subject to the express terms and conditions set forth herein, the Committee shall have the power from time to time:

- (a) to construe and interpret the Plan and the Options and Awards granted hereunder and to establish, amend and revoke rules and regulations for the administration of the Plan, including, but not limited to, correcting any defect or supplying any omission, or reconciling any inconsistency in the Plan or in any Agreement, in the manner and to the extent it shall deem necessary or advisable so that the Plan complies with applicable law including Rule 16b-3 under the Exchange Act and the Code to the extent applicable, and otherwise to make the Plan fully effective. All decisions and determinations by the Committee in the exercise of this power shall be final, binding and conclusive upon the Company, its Subsidiaries, the Optionees and Grantees and all other persons having any interest therein;
- (b) to determine the duration and purposes for leaves of absence which may be granted to an Optionee or Grantee on an individual basis without constituting a termination of employment or service for purposes of the Plan;
- (c) to exercise its discretion with respect to the powers and rights granted to it as set forth in the Plan; and
- (d) generally, to exercise such powers and to perform such acts as are deemed necessary or advisable to promote the best interests of the Company with respect to the Plan.

#### 3.4 Board Reservation and Delegation.

The Board may, in its discretion, reserve to itself or delegate to another committee of the Board any or all of the authority and responsibility of the Committee with respect to Options and Awards granted hereunder to Eligible Individuals who are not subject to Section 16 of the Exchange Act or Section 162(m) of the Code at the time any such delegated authority or responsibility is exercised. Such other committee may consist of one or more directors who may, but need not be, officers or employees of the Company or of any of its Subsidiaries. To the extent that the Board has reserved to itself or delegated the authority and responsibility of the Committee to such other committee, all references to the Committee in the Plan shall be to the Board or to such other committee.

4. Stock Subject to the Plan.

4.1 The maximum number of Shares that may be made the subject of Options and Awards granted under the Plan is 600,000; provided, however, that, in the aggregate, not more than one-third of the number of allotted shares may be made the subject of Restricted Stock Awards under the Plan and, provided, further, however, that the maximum number of Shares that any Eligible Individual may receive during the term of the Plan in respect of Options and Awards may not exceed 400,000 Shares and the maximum dollar amount that any Eligible Individual may receive during the term of the Plan in respect of Performance Units denominated in dollars may not exceed \$5,000,000. Upon a Change in Capitalization the maximum number of Shares shall be adjusted in number and kind pursuant to Section 13. The Company shall reserve for the purposes of the Plan, out of its authorized but unissued Shares or out of Shares held in the Company's treasury, or partly out of each, such number of Shares as shall be determined by the Board.

4.2 Upon the granting of an Option or an Award, the number of Shares available under Section 4.1 for the granting of further Options and Awards shall be reduced as follows:

(a) In connection with the granting of an Option or an Award (other than the granting of a Performance Unit denominated in dollars), the number of Shares shall be reduced by the number of Shares in respect of which the Option or Award is granted or denominated.

(b) In connection with the granting of a Performance Unit denominated in dollars, the number of Shares shall be reduced by an amount equal to the quotient of (i) the dollar amount in which the Performance Unit is denominated, divided by (ii) the Fair Market Value of a Share on the date the Performance Unit is granted.

4.3 Whenever any outstanding Option or Award or portion thereof expires, is cancelled or is otherwise terminated for any reason without having been exercised or payment having been made in respect of the entire Option or Award, the Shares allocable to the expired, cancelled or otherwise terminated portion of the Option or Award may again be the subject of Options or Awards granted hereunder.

4.4 Notwithstanding anything contained in this Section 4, the number of Shares available for Options and Awards at any time under the Plan shall be reduced to such lesser amount as may be required pursuant to the methods of calculation necessary so that the exemptions provided pursuant to Rule 16b-3 under the Exchange Act will continue to be available for transactions involving all current and future Options and Awards. In addition, during the period that any Options and

Awards remain outstanding under the Plan, the Committee may make good faith adjustments with respect to the number of Shares attributable to such Options and Awards for purposes of calculating the maximum number of Shares available for the granting of future Options and Awards under the Plan, provided that following such adjustments the exemptions provided pursuant to Rule 16b-3 under the Exchange Act will continue to be available for transactions involving all current and future Options and Awards.

5. Option Grants for Eligible Individuals.

5.1 Authority of Committee. Subject to the provisions of the Plan and to Section 4.1 above, the Committee shall have full and final authority to select those Eligible Individuals who will receive Options (each, an "Employee Option"), the terms and conditions of which shall be set forth in an Agreement; provided, however, that no person shall receive any Incentive Stock Options unless he or she is an employee of the Company, a Parent or a Subsidiary at the time the Incentive Stock Option is granted.

5.2 Purchase Price. The purchase price or the manner in which the purchase price is to be determined for Shares under each Employee Option shall be determined by the Committee and set forth in the Agreement; provided, however, that the purchase price per Share under each Employee Option shall not be less than 100% of the Fair Market Value of a Share on the date the Employee Option is granted (110% in the case of an Incentive Stock Option granted to a Ten-Percent Stockholder).

5.3 Maximum Duration. Employee Options granted hereunder shall be for such term as the Committee shall determine, provided that an Incentive Stock Option shall not be exercisable after the expiration of ten (10) years from the date it is granted (five (5) years in the case of an Incentive Stock Option granted to a Ten-Percent Stockholder) and a Nonqualified Stock Option shall not be exercisable after the expiration of ten (10) years from the date it is granted. The Committee may, subsequent to the granting of any Employee Option, extend the term thereof but in no event shall the term as so extended exceed the maximum term provided for in the preceding sentence.

5.4 Vesting. Subject to Section 7.4 hereof, each Employee Option shall become exercisable in such installments (which need not be equal) and at such times as may be designated by the Committee and set forth in the Agreement. To the extent not exercised, installments shall accumulate and be exercisable, in whole or in part, at any time after becoming exercisable, but not later than the date the Employee Option expires. The Committee may accelerate the exercisability of any Option or portion thereof at any time.

**5.5 Modification or Substitution.** The Committee may, in its discretion, modify outstanding Employee Options or accept the surrender of outstanding Employee Options (to the extent not exercised) and grant new Employee Options in substitution for them; provided, however, that, no modification or substitution may reduce or have the effect of reducing the per share purchase price of any outstanding Employee Option. Notwithstanding the foregoing, no modification of an Employee Option shall adversely alter or impair any rights or obligations under the Employee Option without the Optionee's consent.

**6. Option Grants for Nonemployee Directors.**

**6.1** Subject to the provisions of the Plan and to Section 4.1, the Committee may grant Director Options to any Nonemployee Director on such terms and conditions, including option price, exercisability and duration, as the Committee in its discretion shall determine. The Committee shall determine the number of Shares subject to each Director Option.

**6.2 Modification.** No modification of a Director Option shall adversely alter or impair any rights or obligations under such Director Option without the Optionee's consent nor shall any modification reduce or have the effect of reducing the per share purchase price of any outstanding Director Option.

**7. Terms and Conditions Applicable to All Options.**

**7.1 Non-transferability.** No Option granted hereunder shall be transferable by the Optionee to whom granted otherwise than by will or the laws of descent and distribution, and an Option may be exercised during the lifetime of such Optionee only by the Optionee or his or her guardian or legal representative. The terms of such Option shall be final, binding and conclusive upon the beneficiaries, executors, administrators, heirs and successors of the Optionee.

**7.2 Method of Exercise.** The exercise of an Option shall be made only by a written notice delivered in person or by mail to the Secretary of the Company at the Company's principal executive office, specifying the number of Shares to be purchased and accompanied by payment therefor and otherwise in accordance with the Agreement pursuant to which the Option was granted and, if the Committee then requires, a fully executed Stockholders Agreement. The purchase price for any Shares purchased pursuant to the exercise of an Option shall be paid in full upon such exercise by any one or a combination of the following: (i) cash or (ii) transferring Shares to the Company upon such terms and conditions as determined by the Committee. Notwithstanding the foregoing, the Committee shall have discretion to determine at the time of grant of each Employee Option or at any later date (up to and including the date of exercise) the form of payment acceptable in respect of the exercise of such Employee Option and Options may be exercised

pursuant to such cashless exercise procedures which are, from time to time, deemed acceptable by the Committee. The written notice pursuant to this Section 7.2 may also provide instructions from the Optionee to the Company that upon receipt of the purchase price in cash from the Optionee's broker or dealer, designated as such on the written notice, in payment for any Shares purchased pursuant to the exercise of an Option, the Company shall issue such Shares directly to the designated broker or dealer. Any Shares transferred to the Company as payment of the purchase price under an Option shall be valued at their Fair Market Value on the day preceding the date of exercise of such Option. If requested by the Committee, the Optionee shall deliver the Agreement evidencing the Option to the Secretary of the Company who shall endorse thereon a notation of such exercise and return such Agreement to the Optionee. No fractional Shares (or cash in lieu thereof) shall be issued upon exercise of an Option and the number of Shares that may be purchased upon exercise shall be rounded to the nearest number of whole Shares.

**7.3    Rights of Optionees.** No Optionee shall be deemed for any purpose to be the owner of any Shares subject to any Option unless and until (i) the Option shall have been exercised pursuant to the terms thereof, (ii) the Company shall have issued and delivered the Shares to the Optionee and (iii) the Optionee's name shall have been entered as a stockholder of record on the books of the Company. Thereupon, the Optionee shall have full voting, dividend and other ownership rights with respect to such Shares.

**7.4    Effect of Change in Control.** In the event of a Change in Control, all Options outstanding on the date of such Change in Control shall become immediately and fully exercisable. In addition, to the extent set forth in an Agreement evidencing the grant of an Option, an Optionee will be permitted to surrender for cancellation within sixty (60) days after such Change in Control, any Option or portion of an Option to the extent not yet exercised and the Optionee will be entitled to receive a cash payment in an amount equal to the excess, if any, of (x) (A) in the case of a Nonqualified Stock Option, the greater of (1) the Fair Market Value, on the date preceding the date of surrender, of the Shares subject to the Option or portion thereof surrendered or (2) the Adjusted Fair Market Value of the Shares subject to the Option or portion thereof surrendered or (B) in the case of an Incentive Stock Option, the Fair Market Value, on the date preceding the date of surrender, of the Shares subject to the Option or portion thereof surrendered, over (y) the aggregate purchase price for such Shares under the Option or portion thereof surrendered; provided, however, that in the case of an Option granted within six (6) months prior to the Change in Control to any Optionee who may be subject to liability under Section 16(b) of the Exchange Act, such Optionee shall be entitled to surrender for cancellation his or her Option during the sixty (60) day period commencing upon the expiration of six (6) months from the date of grant of any such Option. In the event an Optionee's employment with the Company is terminated by the Company within

two years following a Change in Control each Employee Option held by the Optionee that was exercisable as of the date of termination of the Optionee's employment shall remain exercisable for a period ending not before the earlier of the first anniversary of the termination of the Optionee's employment or the expiration of the ordinary term of the Option.

**8. Stock Appreciation Rights.** The Committee may, in its discretion, either alone or in connection with the grant of an Employee Option, grant Stock Appreciation Rights in accordance with the Plan and the terms and conditions of which shall be set forth in an Agreement. If granted in connection with an Employee Option, a Stock Appreciation Right shall cover the same Shares covered by the Employee Option (or such lesser number of Shares as the Committee may determine) and shall, except as provided in this Section 8, be subject to the same terms and conditions as the related Employee Option.

**8.1 Time of Grant.** A Stock Appreciation Right may be granted (i) at any time if unrelated to an Option, or (ii) if related to an Employee Option, either at the time of grant, or at any time thereafter during the term of the Option.

**8.2 Stock Appreciation Right Related to an Employee Option.**

(a) **Exercise.** Subject to Section 8.6, a Stock Appreciation Right granted in connection with an Employee Option shall be exercisable at such time or times and only to the extent that the related Employee Option is exercisable, and will not be transferable except to the extent the related Employee Option is transferable. A Stock Appreciation Right granted in connection with an Incentive Stock Option shall be exercisable only if the Fair Market Value of a Share on the date of exercise exceeds the purchase price specified in the related Incentive Stock Option Agreement.

(b) **Amount Payable.** Upon the exercise of a Stock Appreciation Right related to an Employee Option, the Grantee shall be entitled to receive an amount determined by multiplying (A) the excess of the Fair Market Value of a Share on the date preceding the date of exercise of such Stock Appreciation Right over the per Share purchase price under the related Employee Option, by (B) the number of Shares as to which such Stock Appreciation Right is being exercised. Notwithstanding the foregoing, the Committee may limit in any manner the amount payable with respect to any Stock Appreciation Right by including such a limit in the Agreement evidencing the Stock Appreciation Right at the time it is granted.

(c) **Treatment of Related Options and Stock Appreciation Rights Upon Exercise.** Upon the exercise of a Stock Appreciation Right granted in connection with an Employee Option, the Employee Option shall be cancelled to the extent of the number of Shares as to which the Stock

Appreciation Right is exercised, and upon the exercise of an Employee Option granted in connection with a Stock Appreciation Right or the surrender of such Employee Option pursuant to Section 7.4, the Stock Appreciation Right shall be cancelled to the extent of the number of Shares as to which the Employee Option is exercised or surrendered.

**8.3 Stock Appreciation Right Unrelated to an Option.** The Committee may grant to Eligible Individuals Stock Appreciation Rights unrelated to Options. Stock Appreciation Rights unrelated to Options shall contain such terms and conditions as to exercisability (subject to Section 8.6), vesting and duration as the Committee shall determine, but in no event shall they have a term of greater than ten (10) years. Upon exercise of a Stock Appreciation Right unrelated to an Option, the Grantee shall be entitled to receive an amount determined by multiplying (A) the excess of the Fair Market Value of a Share on the date preceding the date of exercise of such Stock Appreciation Right over the Fair Market Value of a Share on the date the Stock Appreciation Right was granted, by (B) the number of Shares as to which the Stock Appreciation Right is being exercised. Notwithstanding the foregoing, the Committee may limit in any manner the amount payable with respect to any Stock Appreciation Right by including such a limit in the Agreement evidencing the Stock Appreciation Right at the time it is granted.

**8.4 Method of Exercise.** Stock Appreciation Rights shall be exercised by a Grantee only by a written notice delivered in person or by mail to the Secretary of the Company at the Company's principal executive office, specifying the number of Shares with respect to which the Stock Appreciation Right is being exercised. If requested by the Committee, the Grantee shall deliver the Agreement evidencing the Stock Appreciation Right being exercised and the Agreement evidencing any related Employee Option to the Secretary of the Company who shall endorse thereon a notation of such exercise and return such Agreement to the Grantee.

**8.5 Form of Payment.** Payment of the amount determined under Sections 8.2(b) or 8.3 may be made in the discretion of the Committee, solely in whole Shares in a number determined at their Fair Market Value on the date preceding the date of exercise of the Stock Appreciation Right, or solely in cash, or in a combination of cash and Shares. If the Committee decides to make full payment in Shares and the amount payable results in a fractional Share, payment for the fractional Share will be made in cash. Notwithstanding the foregoing, no payment in the form of cash may be made upon the exercise of a Stock Appreciation Right pursuant to Sections 8.2(b) or 8.3 to a Grantee who is an officer of the Company or a Subsidiary who is subject to liability under Section 16(b) of the Exchange Act, unless the exercise of such Stock Appreciation Right is made either (i) during the period beginning on the third business day and ending on the twelfth business day following the date of release for publication of the Company's quarterly or annual statements of earnings or (ii) pursuant to an irrevocable election to receive cash

made at least six months prior to the exercise of such Stock Appreciation Right.

**8.6    Restrictions.** No Stock Appreciation Right may be exercised before the date six (6) months after the date it is granted.

**8.7    Modification or Substitution.** Subject to the terms of the Plan, the Committee may modify outstanding Awards of Stock Appreciation Rights or accept the surrender of outstanding Awards of Stock Appreciation Rights (to the extent not exercised) and grant new Awards in substitution for them. Notwithstanding the foregoing, no modification of an Award shall adversely alter or impair any rights or obligations under the Agreement without the Grantee's consent.

**8.8    Effect of Change in Control.** In the event of a Change in Control, subject to Section 8.6, all Stock Appreciation Rights shall become immediately and fully exercisable. Notwithstanding Sections 8.3 and 8.5, to the extent set forth in an Agreement evidencing the grant of a Stock Appreciation Right unrelated to an Option, upon the exercise of such a Stock Appreciation Right or any portion thereof during the sixty (60) day period following a Change in Control, the amount payable shall be in cash and shall be an amount equal to the excess, if any, of (A) the greater of (x) the Fair Market Value, on the date preceding the date of exercise, of the Shares subject to Stock Appreciation Right or portion thereof exercised and (y) the Adjusted Fair Market Value, on the date preceding the date of exercise, of the Shares over (B) the aggregate Fair Market Value, on the date the Stock Appreciation Right was granted, of the Shares subject to the Stock Appreciation Right or portion thereof exercised; provided, however, that in the case of a Stock Appreciation Right granted within six (6) months prior to the Change in Control to any Grantee who may be subject to liability under Section 16(b) of the Exchange Act, such Grantee shall be entitled to exercise his Stock Appreciation Right during the sixty (60) day period commencing upon the expiration of six (6) months from the date of grant of any such Stock Appreciation Right.

## **9.    Restricted Stock.**

**9.1    Grant.** The Committee may grant to Eligible Individuals Awards of Restricted Stock, and may issue Shares of Restricted Stock in payment in respect of vested Performance Units (as hereinafter provided in Section 10.2), which shall be evidenced by an Agreement between the Company and the Grantee. Each Agreement shall contain such restrictions, terms and conditions as the Committee may, in its discretion, determine and (without limiting the generality of the foregoing) such Agreements may require that an appropriate legend be placed on Share certificates. Awards of Restricted Stock shall be subject to the terms and provisions set forth below in this Section 9.

**9.2    Rights of Grantee.** Shares of Restricted Stock granted pursuant to an Award hereunder shall be issued in the name of the Grantee as soon as reasonably

practicable after the Award is granted provided that the Grantee has executed an Agreement evidencing the Award, the appropriate blank stock powers and, in the discretion of the Committee, an escrow agreement and any other documents which the Committee may require as a condition to the issuance of such Shares. If a Grantee shall fail to execute the Agreement evidencing a Restricted Stock Award, the appropriate blank stock powers and, in the discretion of the Committee, an escrow agreement and any other documents which the Committee may require within the time period prescribed by the Committee at the time the Award is granted, the Award shall be null and void. At the discretion of the Committee, Shares issued in connection with a Restricted Stock Award shall be deposited together with the stock powers with an escrow agent (which may be the Company) designated by the Committee. Unless the Committee determines otherwise and as set forth in the Agreement, upon delivery of the Shares to the escrow agent, the Grantee shall have all of the rights of a stockholder with respect to such Shares, including the right to vote the Shares and to receive all dividends or other distributions paid or made with respect to the Shares.

**9.3 Non-transferability.** Until any restrictions upon the Shares of Restricted Stock awarded to a Grantee shall have lapsed in the manner set forth in Section 9.4, such Shares shall not be sold, transferred or otherwise disposed of and shall not be pledged or otherwise hypothecated, nor shall they be delivered to the Grantee.

**9.4 Lapse of Restrictions.**

(a) **Generally**. Restrictions upon Shares of Restricted Stock awarded hereunder shall lapse at such time or times and on such terms and conditions as the Committee may determine, which restrictions shall be set forth in the Agreement evidencing the Award.

(b) **Effect of Change in Control**. The Committee shall determine at the time of the grant of an Award of Restricted Stock the extent to which, if any, the restrictions upon Shares of Restricted Stock shall lapse upon a Change in Control. The Agreement evidencing the Award shall set forth such provisions.

**9.5 Modification or Substitution.** Subject to the terms of the Plan, the Committee may modify outstanding Awards of Restricted Stock or accept the surrender of outstanding Shares of Restricted Stock (to the extent the restrictions on such Shares have not yet lapsed) and grant new Awards in substitution for them. Notwithstanding the foregoing, no modification of an Award shall adversely

alter or impair any rights or obligations under the Agreement without the Grantee's consent.

**9.6 Treatment of Dividends.** At the time the Award of Shares of Restricted Stock is granted, the Committee may, in its discretion, determine that the payment to the Grantee of dividends, or a specified portion thereof, declared or paid on such Shares by the Company shall be (i) deferred until the lapsing of the restrictions imposed upon such Shares and (ii) held by the Company for the account of the Grantee until such time. In the event that dividends are to be deferred, the Committee shall determine whether such dividends are to be reinvested in Shares (which shall be held as additional Shares of Restricted Stock) or held in cash. If deferred dividends are to be held in cash, there may be credited at the end of each year (or portion thereof) interest on the amount of the account at the beginning of the year at a rate per annum as the Committee, in its discretion, may determine. Payment of deferred dividends in respect of Shares of Restricted Stock (whether held in cash or as additional Shares of Restricted Stock), together with interest accrued thereon, if any, shall be made upon the lapsing of restrictions imposed on the Shares in respect of which the deferred dividends were paid, and any dividends deferred (together with any interest accrued thereon) in respect of any Shares of Restricted Stock shall be forfeited upon the forfeiture of such Shares.

**9.7 Delivery of Shares.** Upon the lapse of the restrictions on Shares of Restricted Stock, the Committee shall cause a stock certificate to be delivered to the Grantee with respect to such Shares, free of all restrictions hereunder.

**10. Performance Awards.**

**10.1 (a) Performance Objectives.** Performance Objectives for Performance Awards may be expressed in terms of (i) earnings per Share, (ii) pre-tax profits, (iii) net earnings, (iv) return on equity or assets, (v) revenues or (vi) any combination of the foregoing. Performance Objectives may be in respect of the performance of the Company and its Subsidiaries (which may be on a consolidated basis), a Subsidiary or a Division. Performance Objectives may be absolute or relative and may be expressed in terms of a progression within a specified range. The Performance Objectives with respect to a Performance Cycle shall be established in writing by the Committee by the earlier of (i) the date on which a quarter of the Performance Cycle has elapsed or (ii) the date which is 90 days after the commencement of the Performance Cycle.

**(b) Determination of Performance.** Prior to the vesting, payment, settlement or lapsing of any restrictions with respect to any Performance Award made to a Grantee who is subject to Section 162(m) of the Code, the Committee shall certify in writing that the applicable Performance Objectives have been satisfied; provided, however, that satisfaction of any applicable Performance Objectives shall be made without regard to any change in accounting standards that may be required after the Performance Objectives

are established.

**10.2 Performance Units.** The Committee, in its discretion, may grant Awards of Performance Units to Eligible Individuals, the terms and conditions of which shall be set forth in an Agreement between the Company and the Grantee. Performance Units may be denominated in Shares or a specified dollar amount and, contingent upon the attainment of specified Performance Objectives within the Performance Cycle, represent the right to receive payment as provided in Section 10.2(b) of (i) in the case of Share-denominated Performance Units, the Fair Market Value of a Share on the date the Performance Unit was granted, the date the Performance Unit became vested or any other date specified by the Committee, (ii) in the case of dollar-denominated Performance Units, the specified dollar amount or (iii) a percentage (which may be more than 100%) of the amount described in clause (i) or (ii) depending on the level of Performance Objective attainment; provided, however, that the Committee may at the time a Performance Unit is granted, specify a maximum amount payable in respect of a vested Performance Unit. Each Agreement shall specify the number of the Performance Units to which it relates, the Performance Objectives which must be satisfied in order for the Performance Units to vest and the Performance Cycle within which such Performance Objectives must be satisfied.

(a) **Vesting and Forfeiture.** Subject to Section 10.1(b) and 10.4, a Grantee shall become vested with respect to the Performance Units to the extent that the Performance Objectives set forth in the Agreement are satisfied for the Performance Cycle.

(b) **Payment of Awards.** Payment to Grantees in respect of vested Performance Units shall be made within sixty (60) days after the last day of the Performance Cycle to which such Award relates unless the Agreement evidencing the Award provides for the deferral of payment, in which event the terms and conditions of the deferral shall be set forth in the Agreement. Subject to Section 10.4, such payments may be made entirely in Shares valued at their Fair Market Value as of the last day of the applicable Performance Cycle or such other date specified by the Committee, entirely in cash, or in such combination of Shares and cash as the Committee in its discretion, shall determine at any time prior to such payment; provided, however, that if the Committee in its discretion determines to make such payment entirely or partially in Shares of Restricted Stock, the Committee must determine the extent to which such payment will be in Shares of Restricted Stock and the terms of such Restricted Stock at the time the Award is granted.

**10.3 Performance Shares.** The Committee, in its discretion, may grant Awards

of Performance Shares to Eligible Individuals, the terms and conditions of which shall be set forth in an Agreement between the Company and the Grantee. Each Agreement may require that an appropriate legend be placed on Share certificates. Awards of Performance Shares shall be subject to the following terms and provisions:

- (a) Rights of Grantee. The Committee shall provide at the time an Award of Performance Shares is made, the time or times at which the actual Shares represented by such Award shall be issued in the name of the Grantee; provided, however, that no Performance Shares shall be issued until the Grantee has executed an Agreement evidencing the Award, the appropriate blank stock powers and, in the discretion of the Committee, an escrow agreement and any other documents which the Committee may require as a condition to the issuance of such Performance Shares. If a Grantee shall fail to execute the Agreement evidencing an Award of Performance Shares, the appropriate blank stock powers and, in the discretion of the Committee, an escrow agreement and any other documents which the Committee may require within the time period prescribed by the Committee at the time the Award is granted, the Award shall be null and void. At the discretion of the Committee, Shares issued in connection with an Award of Performance Shares shall be deposited together with the stock powers with an escrow agent (which may be the Company) designated by the Committee. Except as restricted by the terms of the Agreement, upon delivery of the Shares to the escrow agent, the Grantee shall have, in the discretion of the Committee, all of the rights of a stockholder with respect to such Shares, including the right to vote the Shares and to receive all dividends or other distributions paid or made with respect to the Shares.
- (b) Non-transferability. Until any restrictions upon the Performance Shares awarded to a Grantee shall have lapsed in the manner set forth in Sections 10.3(c) or 10.4, such Performance Shares shall not be sold, transferred or otherwise disposed of and shall not be pledged or otherwise hypothecated, nor shall they be delivered to the Grantee. The Committee may also impose such other restrictions and conditions on the Performance Shares, if any, as it deems appropriate.
- (c) Lapse of Restrictions. Subject to Sections 10.1(b) or 10.4, restrictions upon Performance Shares awarded hereunder shall lapse and such Performance Shares shall become vested at such time or times and on such terms, conditions and satisfaction of Performance Objectives as the Committee may, in its discretion, determine at the time an Award is granted.
- (d) Treatment of Dividends. At the time the Award of Performance Shares is granted, the Committee may, in its discretion, determine that the

payment to the Grantee of dividends, or a specified portion thereof, declared or paid on actual Shares represented by such Award which have been issued by the Company to the Grantee shall be (i) deferred until the lapsing of the restrictions imposed upon such Performance Shares and (ii) held by the Company for the account of the Grantee until such time. In the event that dividends are to be deferred, the Committee shall determine whether such dividends are to be reinvested in shares of Stock (which shall be held as additional Performance Shares) or held in cash. If deferred dividends are to be held in cash, there may be credited at the end of each year (or portion thereof) interest on the amount of the account at the beginning of the year at a rate per annum as the Committee, in its discretion, may determine. Payment of deferred dividends in respect of Performance Shares (whether held in cash or in additional Performance Shares), together with interest accrued thereon, if any, shall be made upon the lapsing of restrictions imposed on the Performance Shares in respect of which the deferred dividends were paid, and any dividends deferred (together with any interest accrued thereon) in respect of any Performance Shares shall be forfeited upon the forfeiture of such Performance Shares.

(e) Delivery of Shares. Upon the lapse of the restrictions on Performance Shares awarded hereunder, the Committee shall cause a stock certificate to be delivered to the Grantee with respect to such Shares, free of all restrictions hereunder.

**10.4 Effect of Change in Control.** In the event of a Change in Control:

(a) With respect to the Performance Units, the Grantee shall (i) become vested in a percentage of Performance Units as determined by the Committee at the time of the Award of such Performance Units and as set forth in the Agreement and (ii) be entitled to receive in respect of all Performance Units which become vested as a result of a Change in Control, a cash payment within ten (10) days after such Change in Control in an amount as determined by the Committee at the time of the Award of such Performance Unit and as set forth in the Agreement.

(b) With respect to the Performance Shares, restrictions shall lapse immediately on all or a portion of the Performance Shares as determined by the Committee at the time of the Award of such Performance Shares and as set forth in the Agreement.

(c) The Agreements evidencing Performance Shares and Performance Units shall provide for the treatment of such Awards (or portions thereof) which do not become vested as the result of a Change in Control, including, but not limited to, provisions for the adjustment of applicable Performance Objectives.

**10.5 Modification or Substitution.** Subject to the terms of the Plan, the Committee may modify outstanding Performance Awards or accept the surrender of outstanding Performance Awards and grant new Performance Awards in substitution for them. Notwithstanding the foregoing, no modification of a Performance Award shall adversely alter or impair any rights or obligations under the Agreement without the Grantee's consent.

**11. Dividend Equivalent Rights.**

Dividend Equivalent Rights may be granted to Eligible Individuals and Nonemployee Directors in tandem with of another Award or as a separate Award. The terms and conditions applicable to each Dividend Equivalent Right shall be specified in the Agreement under which the Dividend Equivalent Right is granted. Amounts payable in respect of Dividend Equivalent Rights may be payable currently or deferred until the lapsing of restrictions on such Dividend Equivalent Rights or until the vesting, exercise, payment, settlement or other lapse of restrictions on the Award to which the Dividend Equivalent Rights relate. In the event that the amount payable in respect of Dividend Equivalent Rights are to be deferred, the Committee shall determine whether such amounts are to be held in cash or reinvested in Shares or deemed (notionally) to be reinvested in Shares. If amounts payable in respect of Dividend Equivalent Rights are to be held in cash, there may be credited at the end of each year (or portion thereof) interest on the amount of the account at the beginning of the year at a rate per annum as the Committee, in its discretion, may determine. Dividend Equivalent Rights may be settled in cash or Shares or a combination thereof, in a single installment or multiple installments.

**12. Effect of a Termination of Employment.**

The Agreement evidencing the grant of each Option and each Award shall set forth the terms and conditions applicable to such Option or Award upon a termination of the employment or service (or other change in the status) of the Optionee or Grantee by the Company, a Subsidiary or a Division (including a termination or change by reason of the sale of a Subsidiary or a Division), as the Committee may, in its discretion, determine at the time the Option or Award is granted or thereafter.

**13. Adjustment Upon Changes in Capitalization.**

(a) In the event of a Change in Capitalization, the Committee shall conclusively determine the appropriate adjustments, if any, to the (i) maximum number and class of Shares or other stock or securities with respect to which Options or Awards may be granted under the Plan, (ii) the number and class of Shares or other stock or securities which are subject to outstanding Options or Awards granted under the Plan, and the purchase price therefor, if applicable and (iii) the Performance Objectives relating to outstanding Awards.

- (b) Any such adjustment in the Shares or other stock or securities subject to outstanding Incentive Stock Options (including any adjustments in the purchase price) shall be made in such manner as not to constitute a modification as defined by Section 424(h)(3) of the Code and only to the extent otherwise permitted by Sections 422 and 424 of the Code.
- (c) If, by reason of a Change in Capitalization, a Grantee of an Award shall be entitled to, or an Optionee shall be entitled to exercise an Option with respect to, new, additional or different shares of stock or securities, such new additional or different shares shall thereupon be subject to all of the conditions, restrictions and performance criteria which were applicable to the Shares subject to the Award or Option, as the case may be, prior to such Change in Capitalization.

14. Effect of Certain Transactions. Subject to Sections 7.4, 8.8, 9.4(b) and 10.4 or as otherwise provided in an Agreement, in the event of (i) the liquidation or dissolution of the Company or (ii) a merger or consolidation of the Company (a "Transaction"), the Plan and the Options and Awards issued hereunder shall continue in effect in accordance with their respective terms and each Optionee and Grantee shall be entitled to receive in respect of each Share subject to any outstanding Options or Awards, as the case may be, upon exercise of any Option or payment or transfer in respect of any Award, the same number and kind of stock, securities, cash, property, or other consideration that each holder of a Share was entitled to receive in the Transaction in respect of a Share.

15. Interpretation.

- (a) The Plan is intended to comply with Rule 16b-3 promulgated under the Exchange Act and the Committee shall interpret and administer the provisions of the Plan or any Agreement in a manner consistent therewith. Any provisions inconsistent with such Rule shall be inoperative and shall not affect the validity of the Plan.
- (b) Unless otherwise expressly stated in the relevant Agreement, each Option, Stock Appreciation Right and Performance Award granted under the Plan is intended to be performance-based compensation within the meaning of Section 162(m)(4)(C) of the Code. The Committee shall not be entitled to exercise any discretion otherwise authorized hereunder with respect to such Options or Awards if the ability to exercise such discretion or the exercise of such discretion itself would cause the compensation attributable to such Options or Awards to fail to qualify as performance-based compensation.

**16. Pooling Transactions.**

Notwithstanding anything contained in the Plan or any Agreement to the contrary, in the event of a Change in Control which also constitutes a Pooling Transaction, the Committee may take such actions which are specifically recommended by an independent accounting firm retained by the Company to the extent reasonably necessary in order to assure that the Pooling Transaction will qualify as such, including but not limited to (i) deferring the vesting, exercise, payment, settlement or lapsing of restrictions with respect to any Option or Award, (ii) providing that the payment or settlement in respect of any Option or Award be made in the form of cash, Shares or securities of a successor or acquiror of the Company, or a combination of the foregoing and (iii) providing for the extension of the term of any Option or Award to the extent necessary to accommodate the foregoing, but not beyond the maximum term permitted for any Option or Award.

**17. Termination and Amendment of the Plan.**

The Plan shall terminate on the day preceding the tenth anniversary of the date of its adoption by the Board and no Option or Award may be granted thereafter. The Board may sooner terminate the Plan and the Board may at any time and from time to time amend, modify or suspend the Plan; provided, however, that:

- (a) No such amendment, modification, suspension or termination shall impair or adversely alter any Options or Awards theretofore granted under the Plan, except with the consent of the Optionee or Grantee, nor shall any amendment, modification, suspension or termination deprive any Optionee or Grantee of any Shares which he or she may have acquired through or as a result of the Plan; and
- (b) To the extent necessary under Section 16(b) of the Exchange Act and the rules and regulations promulgated thereunder or other applicable law, no amendment shall be effective unless approved by the stockholders of the Company in accordance with applicable law and regulations.

**18. Non-Exclusivity of the Plan.**

The adoption of the Plan by the Board shall not be construed as amending, modifying or rescinding any previously approved incentive arrangement or as creating any limitations on the power of the Board to adopt such other incentive arrangements as it may deem desirable, including, without limitation, the granting of stock options otherwise than under the Plan, and such arrangements may be either applicable generally or only in specific cases.

**19. Limitation of Liability.**

As illustrative of the limitations of liability of the Company, but not intended to be exhaustive thereof, nothing in the Plan shall be construed to:

- (i) give any person any right to be granted an Option or Award other than at the sole discretion of the Committee;
- (ii) give any person any rights whatsoever with respect to Shares except as specifically provided in the Plan;
- (iii) limit in any way the right of the Company to terminate the employment of any person at any time; or
- (iv) be evidence of any agreement or understanding, expressed or implied, that the Company will employ any person at any particular rate of compensation or for any particular period of time.

**20. Regulations and Other Approvals; Governing Law.**

20.1 Except as to matters of federal law, this Plan and the rights of all persons claiming hereunder shall be construed and determined in accordance with the laws of the State of Delaware without giving effect to conflicts of law principles.

20.2 The obligation of the Company to sell or deliver Shares with respect to Options and Awards granted under the Plan shall be subject to all applicable laws, rules and regulations, including all applicable federal and state securities laws, and the obtaining of all such approvals by governmental agencies as may be deemed necessary or appropriate by the Committee.

20.3 The Board may make such changes as may be necessary or appropriate to comply with the rules and regulations of any government authority, or to obtain for Eligible Individuals granted Incentive Stock Options the tax benefits under the applicable provisions of the Code and regulations promulgated thereunder.

20.4 (a) Each Option and Award is subject to the requirement that, if at any time the Committee determines, in its discretion, that the listing, registration or qualification of Shares issuable pursuant to the Plan is required by any securities exchange or under any state or federal law, or the consent or approval of any governmental regulatory body is necessary or desirable as a condition of, or in connection with, the grant of an Option or Award or the issuance of Shares, no Options or Awards shall be granted or payment made or Shares issued, in whole or in part, unless listing, registration,

qualification, consent or approval has been effected or obtained free of any conditions as acceptable to the Committee.

(b) Notwithstanding anything to the contrary contained in the Plan or any Agreement, as a prerequisite to the granting, vesting, payment, settlement or lapsing of restrictions with respect to an Option or Award, the Committee may require the Optionee or Grantee, as the case may be, to execute and deliver a Stockholders Agreement in a form acceptable to the Committee.

20.5 Notwithstanding anything contained in the Plan or any Agreement to the contrary, in the event that the disposition of Shares acquired pursuant to the Plan is not covered by a then current registration statement under the Securities Act of 1933, as amended, and is not otherwise exempt from such registration, such Shares shall be restricted against transfer to the extent required by the Securities Act of 1933, as amended, and Rule 144 or other regulations thereunder. The Committee may require any individual receiving Shares pursuant to an Option or Award granted under the Plan, as a condition precedent to receipt of such Shares, to represent and warrant to the Company in writing that the Shares acquired by such individual are acquired without a view to any distribution thereof and will not be sold or transferred other than pursuant to an effective registration thereof under said Act or pursuant to an exemption applicable under the Securities Act of 1933, as amended, or the rules and regulations promulgated thereunder. The certificates evidencing any of such Shares shall be appropriately amended to reflect their status as restricted securities as aforesaid.

21. Miscellaneous.

21.1 Multiple Agreements. The terms of each Option or Award may differ from other Options or Awards granted under the Plan at the same time, or at some other time. The Committee may also grant more than one Option or Award to a given Eligible Individual during the term of the Plan, either in addition to, or in substitution for, one or more Options or Awards previously granted to that Eligible Individual.

21.2 Withholding of Taxes. (a) The Company shall have the right to deduct from any distribution of cash to any Optionee or Grantee, an amount equal to the federal, state and local income taxes and other amounts as may be required by law to be withheld (the "Withholding Taxes") with respect to any Option or Award. If an Optionee or Grantee is to experience a taxable event in connection with the receipt of Shares pursuant to an Option exercise or payment or vesting of an Award (a "Taxable Event"), the Optionee or Grantee shall pay the Withholding Taxes to the Company prior to the issuance, or release from escrow, of such Shares. In satisfaction of the obligation to pay Withholding Taxes to the Company, the Optionee or Grantee may make a written election (the "Tax Election"), which may be accepted or rejected in the discretion of the Committee, to have withheld a

portion of the Shares then issuable to him or her having an aggregate Fair Market Value, on the date preceding the date of such issuance, equal to the Withholding Taxes, provided that in respect of an Optionee or Grantee who may be subject to liability under Section 16(b) of the Exchange Act either: (i) in the case of a Taxable Event involving an Option or an Award (A) the Tax Election is made at least six (6) months prior to the date of the Taxable Event and (B) the Tax Election is irrevocable with respect to all Taxable Events of a similar nature occurring prior to the expiration of six (6) months following a revocation of the Tax Election; or (ii) in the case of the exercise of an Option (A) the Optionee makes the Tax Election at least six (6) months after the date the Option was granted, (B) the Option is exercised during the ten (10) day period beginning on the third business day and ending on the twelfth business day following the release for publication of the Company's quarterly or annual statement of sales and earnings (a "Window Period") and (C) the Tax Election is made during the Window Period in which the related Option is exercised or prior to such Window Period and subsequent to the immediately preceding Window Period; or (iii) in the case of a Taxable Event relating to the payment of an Award (A) the Grantee makes the Tax Election at least six (6) months after the date the Award was granted and (B) the Tax Election is made (x) in the case of a Taxable Event occurring within a Window Period, during the Window Period in which the Taxable Event occurs, or (y) in the case of a Taxable Event not occurring within a window period, during the Window Period immediately preceding the Taxable Event relating to the Award. Notwithstanding the foregoing, the Committee may, by the adoption of rules or otherwise, (i) modify the provisions of this Section 21.2 or impose such other restrictions or limitations on Tax Elections as may be necessary to ensure that the Tax Elections will be exempt transactions under Section 16(b) of the Exchange Act, and (ii) permit Tax Elections to be made at such other times and subject to such other conditions as the Committee determines will constitute exempt transactions under Section 16(b) of the Exchange Act.

(b) If an Optionee makes a disposition, within the meaning of Section 424(c) of the Code and regulations promulgated thereunder, of any Share or Shares issued to such Optionee pursuant to the exercise of an Incentive Stock Option within the two-year period commencing on the day after the date of the grant or within the one-year period commencing on the day after the date of transfer of such Share or Shares to the Optionee pursuant to such exercise, the Optionee shall, within ten (10) days of such disposition, notify the Company thereof, by delivery of written notice to the Company at its principal executive office.

(c) The Committee shall have the authority, at the time of grant of an Option or Award under the Plan or at any time thereafter, to award tax bonuses to designated Optionees or Grantees, to be paid upon their exercise of Employee Options or payment in respect of Awards granted hereunder. The amount of any such payments shall be determined by the Committee. The Committee shall have full

authority in its absolute discretion to determine the amount of any such tax bonus and the terms and conditions affecting the vesting and payment thereof.

**22. Effective Date.** The effective date of the Plan shall be as determined by the Board, subject only to the approval by the affirmative vote of the holders of a majority of the securities of the Company present, or represented, and entitled to vote at a meeting of stockholders duly held in accordance with the applicable laws of the State of Delaware within twelve (12) months of the adoption of the Plan by the Board.

**EXHIBIT 11.1**

Exhibit 11.1

**DEPARTMENT 56, INC.**  
**COMPUTATION OF NET INCOME AND INCOME BEFORE EXTRAORDINARY ITEM**  
**PER SHARE**  
(In thousands, except per share amounts)

	Year Ended December 30, 1995	Year Ended December 31, 1994	Year Ended January 1, 1994
<b>Primary:</b>			
Income Before Extraordinary Item	<u>\$49,565</u>	<u>\$36,099</u>	<u>\$24,997</u>
Net Income	<u>\$48,253</u>	<u>\$36,099</u>	<u>\$24,997</u>
Weighted average number of common shares outstanding	21,519	21,419	21,327
The number of shares resulting from the assumed exercise of stock options reduced by the number of shares which could have been purchased with the proceeds from such exercise, using the average market price during the period	228	230	217
Weighted average number of common and common equivalent shares	<u>21,747</u>	<u>21,649</u>	<u>21,544</u>
Income Before Extraordinary Item per Common and Common Equivalent Share	<u>\$2.28</u>	<u>\$1.67</u>	<u>\$1.16</u>
Net Income per Common and Common Equivalent Share	<u>\$2.22</u>	<u>\$1.67</u>	<u>\$1.16</u>
<b>Fully Diluted:</b>			
Income Before Extraordinary Item	<u>\$49,565</u>	<u>\$36,099</u>	<u>\$24,997</u>
Net Income	<u>\$48,253</u>	<u>\$36,099</u>	<u>\$24,997</u>
Weighted average number of common shares outstanding	21,519	21,419	21,327
The number of shares resulting from the assumed exercise of stock options reduced by the number of shares which could have been purchased with the proceeds from such exercise, using the greater of average market price during the period or period-end market price	228	245	242
Weighted average number of common and common equivalent shares	<u>21,747</u>	<u>21,664</u>	<u>21,569</u>
Fully Diluted Income Before Extraordinary Item per Common and Common Equivalent Share	<u>\$2.28</u>	<u>\$1.67</u>	<u>\$1.16</u>
Fully Diluted Net Income per Common and Common Equivalent Share	<u>\$2.22</u>	<u>\$1.67</u>	<u>\$1.16</u>

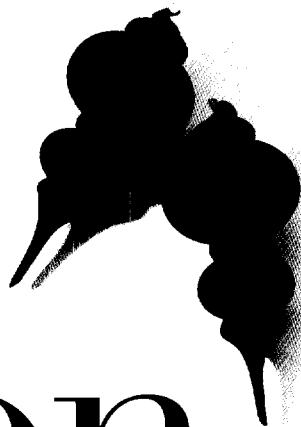
**EXHIBIT 13.1**

DEPARTMENT 56, INC.

1995 Annual Report



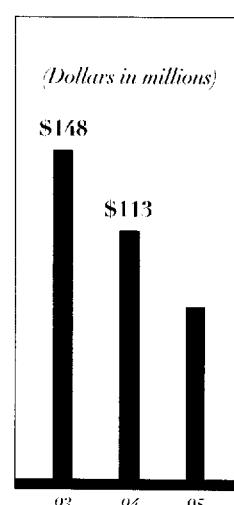
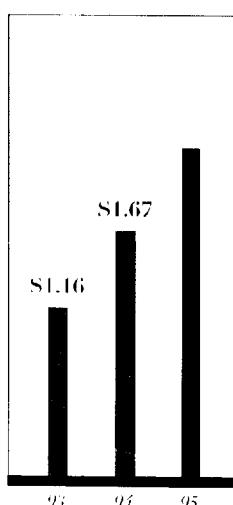
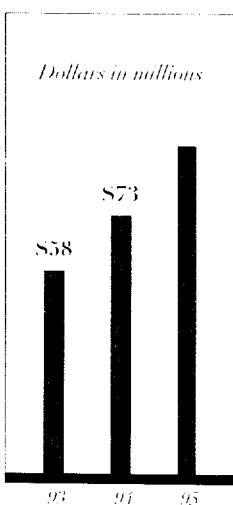
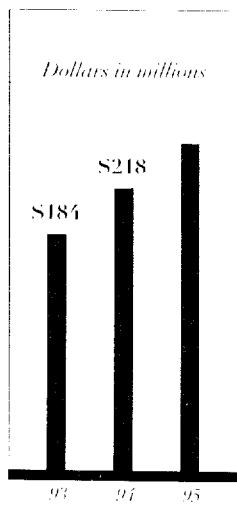
# Building on Tradition



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 49,000 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

<i>Dollars in thousands, except per share amounts</i>	1994	1993
Net Sales .....	\$217,865	\$184,359
Income From Operations <sup>a</sup> .....	72,977	57,783
Net Income <sup>b</sup> .....	36,099	24,997
Net Income Per Share <sup>c</sup> .....	1.67	1.16
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



<sup>a</sup> 1993 income from operations excludes recovery of import duties, and 1995 net income and net income per share also exclude the extraordinary charge due to debt refinancing.

# Product Overview

*Department 56 currently offers more than 2,000 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.*

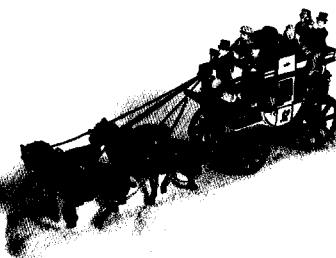
## Villages

1995 SALES: \$175.1 MILLION DEALERS: 5,400

### The Original Snow Village

Introduced	1976
Total Lighted Pieces	190
Current Lighted Pieces	39
Retired Lighted Pieces	151

Current Pieces	268
Retired Pieces	149



### Heritage Village Collection

Introduced	1984
Total Lighted Pieces	215
Current Lighted Pieces	100
Retired Lighted Pieces	115

- The Dickens' Village Series
- The New England Village Series
- The Alpine Village Series
- The Little Town of Bethlehem Series
- The Christmas in the City Series
- The North Pole Series
- Disney Parks Village Series

## Giftware

1995 SALES: \$76.9 MILLION DEALERS: 19,400

### Snowbabies.

Introduced	1986
Total Bisque Pieces	91
Current Bisque Pieces	50
Retired Bisque Pieces	41

### Snowbunnies.

Introduced	1994
Total Pieces	27
Current Pieces	27
Retired Pieces	0



### Current Major Lines

- Angelica
- Mercury Glass
- Noel
- Sugar & Spice



### Current Major Lines

- Coffee Break
- Rooster
- Silver Collection

# Our Shareholders

The Department 56 tradition of growth, innovation, and quality continued to build in fiscal 1995. *We are proud of the role we play in helping families create their own traditions and decorate their homes for the holidays.*

## Exceptional Financial Performance

Department 56 earnings for the fiscal year ended December 31, 1995, increased 32 percent to \$47.9 million, or \$2.20 per share, compared with fiscal 1994 earnings of \$36.1 million, or \$1.67 per share, before an extraordinary charge of \$1.3 million in the first quarter of 1995 and excluding the effect of a \$2.9 million net import duty refund. Net sales rose 16 percent, totaling \$252 million versus \$218 million in the prior year. Our collectible Village Products accounted for 69 percent of total sales. General giftware, which includes Snowbabies, other collectible

products, holiday trim lines and home decorative accessories, accounted for the remaining 31 percent of sales.

Several factors contributed to a higher earnings rate this year. Gross margins significantly improved due to the favorable effects of the GATT agreement and continued benefits from manufacturing efficiencies. In addition, we further leveraged our amortization of goodwill and obtained interest expense savings by applying our strong cash flow to pay down debt.

As baby boomers continue to focus on family and home, their interests—along with a passion for nostalgia and tradition—are poised to sustain a growing collectibles market.



## Building Homes for the Holidays

Department 56 has been building holiday traditions with families for nearly 20 years, whether it be through ornaments on the tree, collectibles throughout the house, or lighted villages carefully created from our extensive assortment of houses and accessories. In the pages that follow, we discuss three overlapping segments of consumers—decorators, gift-givers and collectors—who enjoy our products in many ways. Decorators find the villages appealing for the warmth that just a few pieces can add to their homes during the holiday season. Consumers give and receive village



**Our original designs  
and worldwide  
sourcing capabilities  
have helped establish  
Department 56 as a  
market leader in  
holiday trim lines.**

pieces year-round as gifts for any occasion, thus introducing family and friends to the joy of creating their own holiday traditions. Collectors become involved in the detail and nostalgia of displaying their villages which can range from a few in number to hundreds of pieces.

Our unique product designs and sourcing capabilities, coupled with our dedicated dealer network, give Department 56 important competitive advantages. First, our ability to design proprietary product lines puts us in a select class of companies that create value through their own creative energies. As a result, we are able to constantly revitalize our offerings through new introductions and retirements. Second, the continuity and breadth of our product lines have contributed to making them part of consumers' traditions. Third, relationships we have developed with suppliers enable us to source increasingly intricate, yet affordable, pieces. Fourth, our strategy of limited distribution encourages our retail partners to devote attention to displaying our products and serving consumers to a degree unequaled in the industry.

### Continuing the Traditions

We have built one of the premier consumer products companies in America, yet a large, untapped market still exists for our products. Only a small percentage of American households or collectors own lighted villages like those produced by Department 56. We will continue to expand our marketing initiatives to reach new consumers.

In the fall of 1995, we undertook our most comprehensive and successful marketing program ever, appropriately called "Homes for the Holidays." The objectives of the program included providing current consumers with a means to help others start their own traditions and enticing new collectors to start a tradition for themselves. Our "Start A Tradition Set," a ready-to-display ensemble of houses, accessories and trees was overwhelmingly received in the marketplace.

Our Homes for the Holidays campaign was energized by the involvement of World and Olympic Figure Skating Champion and long-time collector Dorothy Hamill, as well as our efforts to support all 142 Ronald McDonald Houses in North America. Together with our participating dealers, we contributed almost \$500,000, including the decoration of each Ronald McDonald House with our North Pole Series.

### Building the Tradition in 1996

To further strengthen the integrity of our collectible products, early in 1996 we re-evaluated our distribution network. We also initiated a program to help dealers better balance store-level inventories after several years of substantial growth. Even though these actions may have a financial impact in 1996, we believe strongly that both are in the best long-term interest of our retailers, consumers and shareholders and will further strengthen our franchise and position us for continued long-term growth.

We wish to thank our dealers, suppliers, employees and you, our shareholders, for your continued interest and support.

Sincerely,

**Edward R. Bazinet**

Chairman and Chief Executive Officer

**Susan E. Engel**

President and Chief Operating Officer

# Decorating



*collectibles based on their appeal as expressions of the holiday season.*



Villages offer an endless number of decorating ideas for any area of a home.

Whether displaying a few lighted houses on the mantle, adding to a Santa collection or creating a winter Snowbabies scene, more and more families are celebrating with traditions from Department 56.

Each year, millions of consumers renew the tradition of decorating their homes for the holidays. This seasonal celebration represents a substantial growth opportunity for Department 56.



Our core product strengths are key to building sales among established, as well as potential new, consumers. Many holiday decorators already have come to value the trademark styles and intricate detail unique to Department 56 products, and this high regard for our products translates into repeat purchases.

A comprehensive marketing effort to attract new consumers positions Department 56 as the

holiday decorating expert, and demonstrates the many ways our products contribute to lasting holiday traditions. Through brochures, videos and other marketing programs, we provide over 19,000 authorized dealers and their consumers with attractive and affordable ideas for using Department 56 products throughout the house.

Decor  
Decor  
Decor  
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Decor  
Decor



# Gift. Giving



Our 1995 "Start A Tradition Set" featured two lighted houses and all the trimmings to create a holiday scene.



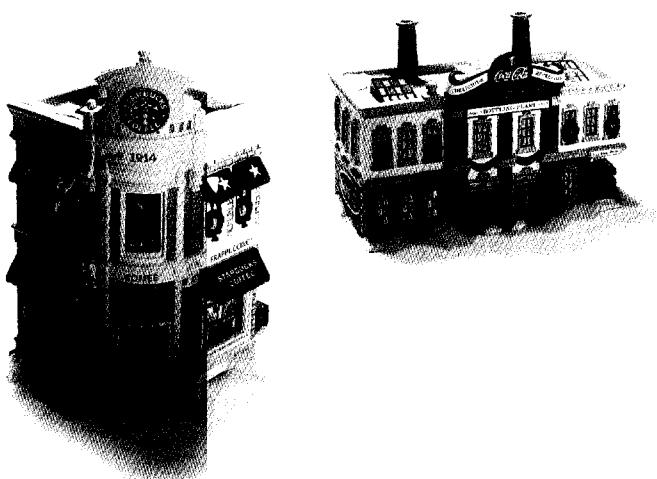
Our ability to market Department 56 products as gifts is a powerful tool in expanding our consumer base. *Our goal in this multi-billion dollar segment is to create year-round Department 56 gift-giving traditions.*



Nearly two-thirds of our collectors say they received their first Village piece as a gift.

The Original Snow Village contains all the nostalgia and variety of a vibrant "Main Street USA." Products in this line make ideal gifts for memorabilia collectors.

**Animated products, like "Up, Up & Away," bring Village scenes to life. These products are designed to complement any of our themed Villages and are often given as gifts.**



We offer a variety of gift opportunities for consumers, with a broad range of distinctive products and price points.

Over the years, Department 56 products have become desirable gifts for many consumers. Our unique product makes gift giving easy and satisfying, supporting a marketing strategy to introduce new families to the Department 56 tradition.

We do this by designing product lines that appeal to a wide range of ages, occupations, interests and hobbies. We also create specially packaged product sets. As part of our "Homes for the Holidays" promotion, we introduced a 13-piece "Start A Tradition Set,"

complete with two new houses for the Dickens' Village, porcelain accessories, road, trees and snow. The set was overwhelmingly successful among first-time buyers, holiday decorators and avid Village collectors, with approximately 20 percent purchasing two or more sets.

Our authorized dealers nationwide are receiving new marketing tools to help introduce their customers, including current collectors and holiday decorators, to the endless number of gifts available from Department 56. It's our experience that, once introduced, consumers come to appreciate the unique design and fine quality of our product lines, which leads to repeat gift purchases.



# Collecting

Almost 20 years after introducing the first lighted houses, *our Villages continue to offer endless potential for unique, new products.*

Our brands are highly regarded throughout the industry, and our authorized dealers represent many of the country's finest retailers. With these resources and an outstanding product we are well positioned to increase our share of the collectibles market, furthering our prospects for long-term growth.

Among all the people who collect, many begin as holiday decorators, or they may give or receive our products as gifts. Over time, some of these consumers move from casual buyers to brand enthusiasts.

Consumers who actively identify themselves as collectors are one of the most important constituencies in our



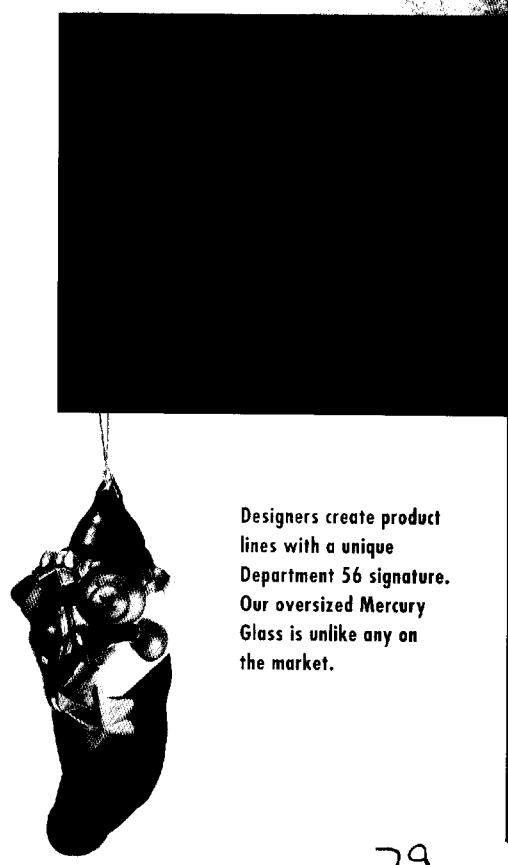
\$7.2 billion industry. Collectors appreciate the enduring design, handcrafted detail and affordable prices they find in Department 56 products. Continuing improvements in our manufacturing process are allowing for even greater design complexity.

Product design and distinctiveness are essential to meet the needs of avid collectors. Our annual product introductions and retirements are much anticipated events in the collecting community. In addition, we periodically offer limited-edition pieces, as well as event pieces for key dealers.

We also publish the *Quarterly*,

a top quality magazine, that informs our consumers of new product introductions, as well as, the history, tradition and decorative uses of our products. It is distributed to more than 140,000 dealers and collectors. This publication reinforces our relationships with our valued consumers.

We are confident that Department 56 products have achieved only a fraction of their market potential. With significant untapped opportunities, our emphasis on product innovation, strong marketing strategies and sound financial management will allow us to continue building our tradition of growth.



Designers create product lines with a unique Department 56 signature. Our oversized Mercury Glass is unlike any on the market.

## Five Year Summary

(In thousands, except per share amounts)	Company					Predecessor Company	
	Year ended Dec. 30, 1995 <sup>1</sup>	Year ended Dec. 31, 1994 <sup>1</sup>	Year ended Jan. 1, 1994 <sup>1</sup>	Year ended Jan. 2, 1993 <sup>1,2</sup>	Oct. 4, 1992– Jan. 2, 1993	Dec. 29, 1991– Oct. 3, 1992	Year ended Dec. 28, 1991 <sup>1</sup>
<b>STATEMENTS OF OPERATIONS</b>							
					<i>(pro forma for the Acquisition)</i>		
Net sales	\$252,047	\$217,865	\$184,359	\$150,754	\$ 24,600	\$125,713	\$121,712
Cost of sales	110,008	98,480	87,331	74,958	12,967	62,485	60,848
Gross profit	142,039	119,385	97,028	75,796	11,633	63,228	60,864
Operating expenses:							
Selling, general and administrative	47,889	41,831	34,670	29,151	7,537	20,678	23,187
Performance bonuses <sup>3</sup>	—	—	—	450	—	6,658	5,654
Amortization of goodwill and trademarks	4,577	4,577	4,575	4,568	1,150	—	—
Nonrecurring charges <sup>4</sup>	—	—	—	—	—	28,350	—
Recovery of import duties <sup>5</sup>	(2,872)	—	—	—	—	—	—
Total operating expenses	49,594	46,408	39,245	34,169	8,687	55,686	28,841
Income from operations	92,445	72,977	57,783	41,627	2,946	7,542	32,023
Other expense (income):							
Interest expense	9,582	12,629	16,143	16,339	4,341	790	1,134
Other, net	(439)	(837)	(1,030)	(1,044)	(304)	(503)	(777)
Income (loss) before income taxes and extraordinary item	83,302	61,185	42,670	26,332	(1,091)	7,255	31,666
Provision (benefit) for income taxes	33,737	25,086	17,673	11,168	(24)	6,887	11,552
Income (loss) before extraordinary item	49,565	36,099	24,997	15,164	(1,067)	368	20,114
Extraordinary charge due to refinancing of debt <sup>6</sup>	1,312	—	—	—	—	—	—
Net income (loss)	<u>\$ 48,253</u>	<u>\$ 36,099</u>	<u>\$ 24,997</u>	<u>\$ 15,164</u>	<u>\$ (1,067)</u>	<u>\$ 368</u>	<u>\$ 20,114</u>
Income (loss) before extraordinary item per share	<u>\$ 2.28</u>	<u>\$ 1.67</u>	<u>\$ 1.16</u>	<u>\$ .70</u>	<u>\$ (.05)</u>	<u>—</u>	<u>—</u>
Net income (loss) per share	<u>\$ 2.22</u>	<u>\$ 1.67</u>	<u>\$ 1.16</u>	<u>\$ .70</u>	<u>\$ (.05)</u>	<u>—</u>	<u>—</u>
	<i>Dec. 30, 1995</i>	<i>Dec. 31, 1994</i>	<i>Jan. 1, 1994</i>		<i>Jan. 2, 1993</i>		<i>Dec. 28, 1991</i>
<b>BALANCE SHEET DATA</b>							
Working capital	\$ 36,015	\$ 13,362	\$ 26,392		\$ 61,697		\$34,138
Total assets	259,085	239,680	234,893		275,370		61,751
Long-term debt, including current maturities	80,000	113,000	148,000		213,000		5,051
Total stockholders' equity <sup>7</sup>	150,286	100,305	61,731		37,158		41,382

<sup>1</sup> The years ended December 28, 1991, January 1, 1994, December 31, 1994 and December 30, 1995 were 52-week periods and the year ended January 2, 1993 was a 53-week period.

<sup>2</sup> In October 1992, D 56, Inc., the principal operating subsidiary of the Company (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.

<sup>3</sup> 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.

<sup>4</sup> Nonrecurring charges include payments to terminate employment contracts, special bonuses and costs incurred by the Predecessor Company in connection with the Acquisition.

<sup>5</sup> Reflects a refund 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).

<sup>6</sup> Reflects an extraordinary charge the Company incurred in connection with its refinancing of debt. (See Note 4 to the Consolidated Financial Statements).

<sup>7</sup> 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 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 continued to account for the most significant portion of the Company's sales, 69% 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. As a result, the Company continued its policy of allocating the amount of Village Series products customers were allowed to purchase in both 1994 and 1995, 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.

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. The Company 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 \$22.7 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.

<i>(In millions, except per share amounts)</i>	1995		1994		1993	
	Dollars	Percent of Net Sales	Dollars	Percent of Net Sales	Dollars	Percent of Net Sales
Net sales	\$252.0	100%	\$217.9	100%	\$184.4	100%
Gross profit	142.0	56	119.4	55	97.0	53
Selling, general and administrative expenses	47.9	19	41.8	19	34.7	19
Amortization of goodwill and trademarks	4.6	2	4.6	2	4.6	2
Recovery of import duties	(2.9)	(1)	—	—	—	—
Income from operations	92.4	37	73.0	33	57.8	31
Interest expense	9.6	4	12.6	6	16.1	9
Other, net	(.4)	—	(.8)	—	(1.0)	(1)
Income before income taxes and extraordinary item	83.3	33	61.2	28	42.7	23
Provision for income taxes	33.7	13	25.1	12	17.7	10
Income before extraordinary item	49.6	20	36.1	17	25.0	14
Extraordinary charge due to refinancing of debt	1.3	1	—	—	—	—
Net income	48.3	19	36.1	17	25.0	14
Income before extraordinary item per share	2.28		1.67		1.16	
Net income per share	2.22		1.67		1.16	
Operating cash flow <sup>1</sup>	99.1		79.7		64.4	

<sup>1</sup> Earnings before interest, income tax, depreciation and amortization expenses.

## Management's Discussion and Analysis

*Recovery of Import Duties* 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.

### 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 General 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. 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.

In General Giftware products, sales increased at a lower rate than the Company's overall sales. The Company 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 long-term debt on December 31, 1993.

*Provision for Income Taxes* The effective income tax rate was 41.4% and 41.0% during 1993 and 1994, respectively.

## 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 76% of its total annual customer orders for 1995 and 1994, during the first quarter of each of those years. Cancellations of total annual customer orders were approximately 7% and 5% in 1995 and 1994, respectively. The Company's backlog was \$11.0 million and \$8.4 million at December 30, 1995 and December 31, 1994, respectively.

The Company shipped and recorded as net sales approximately 91% and 92% of its annual customer orders in 1995 and 1994, 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, the Company generally records its highest sales during the second and third

quarters of each year and expects this 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. See "Recent Developments."

### **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 five consecutive installments of \$20 million, payable in

<i>(In millions, except per share amounts)</i>	1995					1994				
	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	Total	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	Total
Customer orders entered <sup>1</sup>	\$209.9	\$30.0	\$27.3	\$8.6	\$275.8	\$181.0	\$27.0	\$20.2	\$ 8.9	\$237.1
Net sales	53.0	74.8	77.0	47.2	252.0	45.5	64.4	66.4	41.6	217.9
Gross profit	29.7	42.4	43.6	26.3	142.0	24.6	35.4	36.4	23.0	119.4
Selling, general and administrative expenses	10.0	12.2	11.8	13.9	47.9	8.8	10.8	10.5	11.7	41.8
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	—	—	(2.8)	(.1)	(2.9)	—	—	—	—	—
Income from operations	18.5	29.1	33.4	11.4	92.4	14.7	23.5	24.7	10.1	73.0
Income before extraordinary item	9.9	15.9	18.2	5.6	49.6	7.1	12.0	12.8	4.2	36.1
Net income	8.6	15.9	18.2	5.6	48.3	7.1	12.0	12.8	4.2	36.1
Income before extraordinary item per share	0.46	0.73	0.84	0.25	2.28	0.33	0.56	0.59	0.19	1.67
Net income per share	0.40	0.73	0.84	0.25	2.22	0.33	0.56	0.59	0.19	1.67

<sup>1</sup> 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

December of each year, commencing in 1995. 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 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., 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 \$84,960,000 at December 30, 1995.

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 net cash balances peak in December, following the collection in November and December of accounts receivable with extended payment terms. At December 30, 1995, cash and cash equivalents balances were \$7.8 million as compared to \$2.2 million at December 31, 1994.

Accounts receivable increased from \$24.0 million at December 31, 1994 to \$34.3 million at December 30, 1995 principally as a result of increased volume, a larger amount of receivables qualifying for December dating terms, and a small change in payment patterns.

During 1995, the Company increased its production capacity, resulting in higher inventory levels than experienced in 1994. The Company believes that, even with this increase, its overall inventory turnover rate is higher

than or equal to that of other large U.S. giftware companies, and that higher inventory levels can enable the Company to better serve its customers. Inventories increased from \$20.4 million at December 31, 1994 to \$29.1 million at December 30, 1995.

Capital expenditures were \$1.6 million, \$2.6 million and \$1.3 million for 1995, 1994 and 1993, respectively.

Operating cash flow, defined as earnings before interest, income tax, depreciation and amortization expenses, increased \$19.4 million, or 24%, from \$79.7 million in 1994 to \$99.1 million in 1995. The increase was principally due to the increase in income before income taxes.

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 \$27.375 per share and received net cash proceeds from the offering of approximately \$150.3 million.

On May 15, 1995 and on May 23, 1995, the Forstmann Little Partnerships and a member of senior management completed a public offering of 5.75 million shares of the Company's common stock at a price of \$37.625 and received net cash proceeds from the offering of approximately \$207.7 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

## Management's Discussion and Analysis

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 30, 1995, the Company had \$35.0 million of foreign exchange contracts outstanding to hedge 1996 Taiwan dollar denominated inventory purchases. These contracts mature from January 1996 through November 1996 at a rate of approximately 27.00 NT\$/USS.

### 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 12, 1996, the Company issued a press release stating, in relevant part: "Department 56 also announced the implementation of several steps to further strengthen the quality of its distribution, protect its premium brand equity and reinforce its long-term market prospects. The Company implemented an inventory management initiative to help dealers better balance store-level inventories after several years of high growth, and to assist the Company in fine-tuning its collectible products allocation policy, helping dealers carry appropriate inventory levels. In addition, the Company has terminated approximately 50 accounts, including one of its largest department store customers, that in 1995 violated the Company's collectible merchandising guidelines."

These actions, which facilitated a rebalancing of dealer inventory levels, are expected to have a negative effect on first-quarter 1996 orders, which are projected to be approximately 10% lower than during the same period in 1995. Even so, full year earnings for 1996 are expected to equal or exceed 1995 earnings. Actual results may vary from these forecasts."

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 others, the forecast set forth in this press release regarding first quarter 1996 orders is based on the following assumptions:

- The order trend experience on orders received from existing and new customers from the beginning of 1996 to date will continue with respect to accounts of similar type through the end of the first quarter of 1996
- The number, mix and timing of customers ordering during the first quarter of 1996 will be similar to that experienced during the first quarter 1995
- General and giftware-industry economic conditions will remain stable

Among others, the forecast set forth in this press release regarding 1996 earnings is based on the following assumptions:

- The 1996 first quarter order forecast set forth in the press release will be realized
- Annual sales will be more favorable than the actual first quarter order rate would historically suggest
- Customer orders for 1996 mid-year product introductions and response to 1996 marketing programs will be at least at historical levels
- Reorder and order cancellation rates will be at least as favorable as historical levels
- There will be a slight increase in gross and net margin rate
- Selling, general and administrative expense rate (relative to net sales) will be consistent overall with 1995 levels other than for the effect of an anticipated increase in marketing expense
- The application of corporate cash flow will benefit earnings
- The regulatory and trade environment will remain stable

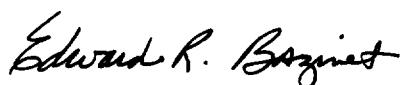
Actual results may vary materially from these forecasts and the assumptions on which they are based. The forward-looking statements in this press release speak as of this date only, and the Company undertakes no obligation to update such forward-looking statements or publish any forward-looking statements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

## 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

Chief Executive Officer



Susan E. Engel

Chief Operating Officer

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## Consolidated Balance Sheets

*(In thousands, except per share amounts)*

*December 30, 1995      December 31, 1994*

### **ASSETS**

#### *Current Assets:*

Cash and cash equivalents	\$ 7,805	\$ 2,180
Accounts receivable, net of allowances of \$6,884 and \$5,232, respectively	34,271	23,959
Inventories	29,059	20,366
Deferred taxes	4,476	3,161
Other current assets	2,068	2,723
<b>Total current assets</b>	<b>77,679</b>	<b>52,389</b>
Property and equipment, net	12,445	12,330
Goodwill, net of accumulated amortization of \$13,425 and \$9,295, respectively	151,749	155,878
Trademarks, net of accumulated amortization of \$1,454 and \$1,007, respectively	16,446	16,893
Other assets	766	2,190
	<b>\$259,085</b>	<b>\$239,680</b>

### **LIABILITIES AND STOCKHOLDERS' EQUITY**

#### *Current Liabilities:*

Current portion of long-term debt	\$ 20,000	\$ 20,000
Accounts payable	6,599	5,157
Commissions payable	4,471	4,209
Accrued interest	151	646
Other current liabilities	10,443	9,015
<b>Total current liabilities</b>	<b>41,664</b>	<b>39,027</b>
Deferred taxes	7,135	7,348
Long-term debt	60,000	93,000

#### *Commitments and contingencies (note 6)*

#### *Stockholders' Equity:*

Preferred stock, \$.01 par value; authorized 20,000 shares; no shares issued	—	—
Common stock, \$.01 par value; authorized 100,000 shares; issued and outstanding 21,546 and 21,475 shares, respectively	215	215
Additional paid-in capital	41,803	40,244
Unearned compensation on common stock options	(14)	(183)
Retained earnings	108,282	60,029
<b>Total stockholders' equity</b>	<b>150,286</b>	<b>100,305</b>
	<b>\$259,085</b>	<b>\$239,680</b>

*See notes to consolidated financial statements.*

## Consolidated Statements of Income

<i>(In thousands, except per share amounts)</i>	<i>Year ended December 30, 1995</i>	<i>Year ended December 31, 1994</i>	<i>Year ended January 1, 1994</i>
Net sales	\$252,047	\$217,865	\$184,359
Cost of sales	110,008	98,480	87,331
Gross profit	142,039	119,385	97,028
Operating expenses:			
Selling, general and administrative	47,889	41,831	34,670
Amortization of goodwill and trademarks	4,577	4,577	4,575
Recovery of import duties	(2,872)	—	—
Total operating expenses	49,594	46,408	39,245
Income from operations	92,445	72,977	57,783
Other expense (income):			
Interest expense	9,582	12,629	16,143
Other, net	(439)	(837)	(1,030)
Income before income taxes and extraordinary item	83,302	61,185	42,670
Provision for income taxes	33,737	25,086	17,673
Income before extraordinary item	49,565	36,099	24,997
Extraordinary charge due to refinancing of debt	1,312	—	—
Net income	<u>\$ 48,253</u>	<u>\$ 36,099</u>	<u>\$ 24,997</u>
Income before extraordinary item per share	<u>\$ 2.28</u>	<u>\$ 1.67</u>	<u>\$ 1.16</u>
Net income per share	<u>\$ 2.22</u>	<u>\$ 1.67</u>	<u>\$ 1.16</u>
Weighted average common and common equivalent shares outstanding	<u>21,747</u>	<u>21,649</u>	<u>21,544</u>

*See notes to consolidated financial statements.*

## Consolidated Statements of Cash Flows

<i>(In thousands)</i>	<i>Year ended December 30, 1995</i>	<i>Year ended December 31, 1994</i>	<i>Year ended January 1, 1994</i>
<i>Cash Flows from Operating Activities:</i>			
Net income	\$ 48,253	\$ 36,099	\$ 24,997
Adjustments to reconcile net income to net cash provided by operating activities:			
Extraordinary charge	1,312	—	—
Depreciation	1,609	1,296	1,037
Amortization of goodwill, trademarks and other intangible assets	4,577	5,254	5,243
Provision for uncollectible accounts receivable	2,293	1,107	1,922
Compensation expense—common stock options	169	498	829
Deferred taxes	(1,528)	203	(682)
Changes in assets and liabilities:			
Accounts receivable	(12,605)	(11,511)	(3,590)
Inventories	(8,693)	(2,971)	(719)
Other assets	520	(361)	(2,299)
Accounts payable	1,442	11	(1,331)
Commissions payable	262	590	1,369
Accrued interest	(495)	(224)	(2,284)
Other current liabilities	2,261	1,403	698
Net cash provided by operating activities	39,377	31,394	25,190
<i>Cash Flows from Investing Activities:</i>			
Sales of marketable securities	—	—	9,870
Purchases of property and equipment	(1,617)	(2,621)	(1,296)
Net cash provided by (used in) investing activities	(1,617)	(2,621)	8,574
<i>Cash Flows from Financing Activities:</i>			
Proceeds from the exercise of common stock options	865	1,041	247
Borrowings on revolving credit agreement	36,500	97,577	—
Principal payments on revolving credit agreement	(41,500)	(92,577)	—
Proceeds from issuance of long-term debt	100,000	—	—
Principal payments on long-term debt	(128,000)	(40,000)	(65,000)
Net cash used in financing activities	(32,135)	(33,959)	(64,753)
Net increase (decrease) in cash and cash equivalents	5,625	(5,186)	(30,989)
Cash and cash equivalents at beginning of period	2,180	7,366	38,355
Cash and cash equivalents at end of period	<u>\$ 7,805</u>	<u>\$ 2,180</u>	<u>\$ 7,366</u>

*See notes to consolidated financial statements.*

## Consolidated Statements of Stockholders' Equity

(In thousands)	<i>Common Stock</i>		<i>Additional Paid-in Capital</i>	<i>Unearned Compensation on Common Stock Options</i>	<i>Retained Earnings (Deficit)</i>	<i>Total Stockholders' Equity</i>
	<i>Shares</i>	<i>Amount</i>				
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
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	<u>21,546</u>	<u>\$215</u>	<u>\$41,803</u>	<u>\$ (14)</u>	<u>\$108,282</u>	<u>\$150,286</u>

*See notes to consolidated financial statements.*

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## Notes to Consolidated Financial Statements

(In thousands, except share and per share amounts)

### 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 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, FL 56 Intermediate Corp., Ed Bazinet International, Inc., 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 January 1, 1994, December 31, 1994, and December 30, 1995 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 China, 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 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.

## Notes to Consolidated Financial Statements

*(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. At December 30, 1995, the Company had nondeliverable Taiwan currency forward contracts with a notional amount of \$35,000 which mature from January 1996 to November 1996. At December 30, 1995, the Company had deferred losses of \$77 in connection with these contracts. These losses 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 and \$433 and \$192 at December 31, 1994, respectively.

**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. 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.

**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 reporting period. Actual results could differ from those estimates.

**New Accounting Standards** In March 1995, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." This Statement requires that assets to be held and used be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. An impairment loss should be recognized when the estimated future cash flows from the asset are less than the carrying value of the asset. Assets to be disposed of should be reported at the lower of their carrying amount or fair value less cost to sell. This Statement is effective for financial statements for fiscal years beginning after December 15, 1995, and adoption by the Company in 1996 is not expected to have a material impact on results of operations or financial position.

In October 1995, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (SFAS 123), "Accounting for Stock-Based Compensation." The Company has elected to continue following the guidance of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," for measurement and recognition of stock-based transactions with employees. The Company will adopt the disclosure provisions of SFAS 123 in 1996.

## Notes to Consolidated Financial Statements

(In thousands, except share and per share amounts)

### Property and Equipment

Property and equipment is comprised of the following:

	Dec. 30, 1995	Dec. 31, 1994
Leasehold improvements	\$ 2,020	\$ 1,172
Furniture and fixtures	2,983	2,588
Equipment	4,518	4,207
Building	5,882	5,876
Land	906	906
	16,309	14,749
Less accumulated depreciation	(3,864)	(2,419)
Property and equipment, net	<u>\$12,445</u>	<u>\$12,330</u>

### Other Current Liabilities

Other current liabilities are comprised of the following:

	Dec. 30, 1995	Dec. 31, 1994
Accrued compensation and benefits	\$ 1,370	\$1,161
Income taxes payable	6,917	5,143
Accrued stock issuance costs	271	853
Accrued royalty fees	1,245	1,348
Other	640	510
	<u>\$10,443</u>	<u>\$9,015</u>

The Company accrued 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.

### Credit Agreement

Long-term debt is comprised of the following:

	Dec. 30, 1995	Dec. 31, 1994
Revolving line of credit	\$ —	\$ 13,000
Term loan .....	80,000	100,000
	80,000	113,000
Less current portion .....	20,000	20,000
	<u>\$60,000</u>	<u>\$ 93,000</u>

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 to refinance the Company's previous long-term debt. 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 five consecutive annual installments of \$20,000, payable in December of each year commencing in 1995.

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  $\frac{1}{4}\%$  to  $\frac{3}{8}\%$  per annum on the daily average of the unused commitment. The available borrowings under the revolving line of credit were \$84,960 at December 30, 1995.

## Notes to Consolidated Financial Statements

(In thousands, except share and per share amounts)

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  $\frac{1}{2}\%$  to  $1\frac{1}{4}\%$  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 \$10,086, \$12,182 and \$17,595 during the years ended December 30, 1995, December 31, 1994 and January 1, 1994, respectively.

### Income Taxes

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

	Year Ended Dec. 30, 1995	Year Ended Dec. 31, 1994	Year Ended Jan. 1, 1994
<b>Current:</b>			
Federal	\$30,560	\$22,339	\$16,680
State	2,619	2,298	1,333
Foreign	272	246	342
Deferred	286	203	(682)
	<b>\$33,737</b>	<b>\$25,086</b>	<b>\$17,673</b>
Income taxes at			
federal statutory rate	\$29,156	\$21,414	\$14,935
State income taxes, net of			
federal income tax benefit	2,566	1,929	1,300
Amortization of goodwill			
and other intangibles	1,448	1,448	1,440
Adjustment to deferred			
tax assets and liabilities			
for the change in the			
federal tax rate	—	—	111
Other	567	295	(113)
Provision for income taxes	<b>\$33,737</b>	<b>\$25,086</b>	<b>\$17,673</b>

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

	Dec. 30, 1995	Dec. 31, 1994
<b>Deferred tax assets:</b>		
Accounts receivable valuation allowances	\$2,704	\$ 1,988
Inventory valuation allowances	1,369	822
Compensation expense—		
common stock options	366	345
Accrued liabilities	620	115
Other	310	49
Total deferred tax assets	<b>5,369</b>	<b>3,319</b>
<b>Deferred tax liabilities:</b>		
Trademarks	(6,249)	(6,419)
Property and equipment	(1,626)	(929)
Other	(153)	(158)
Total deferred tax liabilities	<b>(8,028)</b>	<b>(7,506)</b>
	<b>\$ (2,659)</b>	<b>\$ (4,187)</b>

## Notes to Consolidated Financial Statements

(In thousands, except share and per share amounts)

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 \$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 Company paid income taxes of \$31,855, \$23,677 and \$15,228 during the years ended December 30, 1995, December 31, 1994 and January 1, 1994, respectively.

### Commitments and Contingencies

*Operating Leases* The Company leases an aircraft, warehouse and office space, equipment, and showroom display facilities under renewable 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.

The following is a schedule of future annual minimum lease payments for noncancelable operating leases as of December 30, 1995:

1996	\$ 2,629
1997	2,357
1998	2,370
1999	1,996
2000	1,764
Thereafter	2,272
	<u>\$13,388</u>

The Company's rental expense was \$2,875, \$2,359 and \$1,534 for the years ended December 30, 1995, December 31, 1994 and January 1, 1994, respectively.

*Letters of Credit* The Company had outstanding standby and commercial letters of credit amounting to \$5,040 at December 30, 1995 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 of the Company.

### 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 \$975, \$819 and \$783 for the years ended December 30, 1995, December 31, 1994 and January 1, 1994, respectively.

### Recovery of Import Duties

The Company received a net refund of \$2,872 in custom duties and related interest during the year ended December 30, 1995. The duties refund pertained to certain merchandise imported into the United States from 1989 to 1994.

### 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 30, 1995, December 31, 1994 and January 1, 1994 of \$1,893, \$1,494 and \$1,458, respectively.

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

## Notes to Consolidated Financial Statements

*(In thousands, except share and per share amounts)*

### 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 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 Common Stock at a price of \$27.375 per share.

On May 15, 1995 and on May 23, 1995, FL & Co. and a member of senior management completed a public offering of 5,750,000 shares of Common Stock at a price of \$37.625 per share.

**Stock Options** In 1992, 1993 and 1995, the Company adopted plans which provide for granting stock options to directors, officers, employees, consultants, and advisors to the Company. The options 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. All employee options granted after the initial public offering have an exercise price equal to the market value of the stock at the date of grant. Information regarding the option plans is as follows:

	Number of shares		
	1995	1994	1993
Outstanding at beginning of year	702,755	404,556	22,500
Granted	448,660	424,700	423,900
Exercised	(70,742)	(122,401)	(35,144)
Cancelled	(7,900)	(4,100)	(6,700)
Outstanding at end of year	<u>1,072,773</u>	<u>702,755</u>	<u>404,556</u>
Exercisable at end of year	<u>224,271</u>	<u>32,955</u>	<u>1,951</u>

Options were granted at \$34.63, \$36.31 and \$40.875 per share in 1995, \$34.625 and \$37.75 per share in 1994, and \$3.33 and \$18.00 per share in 1993. Options were exercised at \$3.33 and \$18.00 in 1995, \$3.33 and \$18.00 in 1994, and \$3.33 in 1993. At December 30, 1995, options for 591,440 shares remained available for issuance under the plans.

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 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 30, 1995, directors' options to purchase 130,000 shares of Common Stock were exercisable at \$3.33 per share.

## 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 30, 1995 and December 31, 1994 and the related consolidated statements of income, cash flows and stockholders' equity for the years ended December 30, 1995, December 31, 1994 and January 1, 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 30, 1995 and December 31, 1994 and the results of its operations and its cash flows for the years ended December 30, 1995, December 31, 1994 and January 1, 1994 in conformity with generally accepted accounting principles.

*Deloitte & Touche LLP  
Deloitte & Touche LLP*

Minneapolis, Minnesota

February 14, 1996

## Corporate and Stockholder Information

### Board of Directors

**Edward R. Bazinet**<sup>1</sup>  
*Chairman of the Board and  
 Chief Executive Officer*  
 Department 56, Inc.

**Todd L. Bachman**<sup>2</sup>  
*Chairman of the Board and  
 Chief Executive Officer*  
 Bachman's, Inc.

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

**Nicholas C. Forstmann**<sup>1,3</sup>  
*General Partner*  
 Forstmann Little & Co.

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

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

**Richard S. Friedland**<sup>2</sup>  
*Chairman of the Board and  
 Chief Executive Officer*  
 General Instrument  
 Corporation

**Sandra J. Horbach**<sup>1,3</sup>  
*General Partner*  
 Forstmann Little & Co.

**Wm. Brian Little**<sup>1</sup>  
*Private Investor*

**Steven G. Rothmeier**<sup>2</sup>  
*Chairman of the Board and  
 Chief Executive Officer*  
 Great Northern Capital

**Arthur T. Shorin**<sup>3</sup>  
*Chairman of the Board and  
 Chief Executive Officer*  
 The Topps Co., Inc.

**Vin Weber**  
*Partner*  
 Clark & Weinstock, Inc.

<sup>1</sup> Member of Executive Committee  
<sup>2</sup> Member of Audit Committee  
<sup>3</sup> Member of Compensation Committee

### Officers

**Edward R. Bazinet**  
*Chief Executive Officer*

**Susan E. Engel**  
*President and Chief  
 Operating Officer*

**Mark R. Kennedy**  
*Chief Financial Officer  
 and Vice President—  
 Administration*

**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*

### Stockholder Information

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

**Transfer Agent**  
 Chemical Mellon  
 Shareholder Services  
 450 West 33rd Street  
 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**  
 2:00 p.m.  
 May 16, 1996  
 Chemical Bank  
 270 Park Avenue  
 New York, NY

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

	<i>High</i>	<i>Low</i>
First Quarter	\$ 40%	\$ 33%
Second Quarter	\$ 42	\$ 35%
Third Quarter	\$ 47%	\$ 37%
Fourth Quarter	\$ 48	\$ 32%

	<i>High</i>	<i>Low</i>
First Quarter	\$ 35	\$ 26
Second Quarter	\$ 33%	\$ 26%
Third Quarter	\$ 39	\$ 31½
Fourth Quarter	\$ 40	\$ 34

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 20, 1996, there were 825 record holders of the Company's common stock.

Department 56  
INC

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

100

**EXHIBIT 21.1**

Exhibit 21.1

**SUBSIDIARIES OF THE COMPANY**

<u>Name of Subsidiary</u>	<u>Jurisdiction of Organization</u>
FL56 Intermediate Corp.	Delaware
ed bazinet international, inc.	Minnesota
D 56, Inc.	Minnesota
Department 56 Trading Co., Ltd.	Delaware
Browndale Tanley Limited	Hong Kong

**EXHIBIT 23.1**

**Exhibit 23.1**

**INDEPENDENT AUDITORS' CONSENT**

We consent to the incorporation by reference in Registration Statements No. 33-95704 and No. 33-79960 of Department 56, Inc. on Form S-8 of our reports dated February 14, 1996, included in and incorporated by reference in this Annual Report of Department 56, Inc. on Form 10-K for the year ended December 30, 1995.

*Deloitte & Touche LLP*

Deloitte & Touche LLP  
Minneapolis, Minnesota  
March 28, 1996