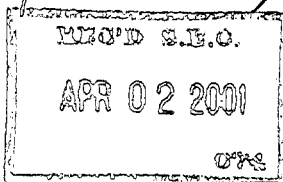




AR/s DEPARTMENT 56, INC

12/30/00



1-11908



DEPARTMENT 

56 ANNUAL REPORT

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A JOYFUL TRADITION

One Christmas evening years ago, a group of friends set off to enjoy a celebration at a country inn located in a quiet river town. As they rounded a bend in the road, they saw the small, quaint village, decorated for the holidays with lights that glowed in the fresh fallen snow. This vision inspired the Department 56 *Original Snow Village* – a nostalgic collection of miniature ceramic buildings that evoked memories of yesteryear. For the past 25 years, millions of people have experienced the joy of our magical gifts. Over the years, our product line has blossomed into a year-round gift-giving and decorating experience. As our friends and their families cherish each carefully handcrafted piece, our collectibles and giftware come to represent a way of life – a joyful tradition handed down from one generation to the next.





Illustrated in 1926 Department 56 gave the world the *Original Snow Village*.



IT STARTED WITH A
HOUSE ... AND GREW
INTO A TRADITION

DEAR FELLOW SHAREHOLDERS

Fiscal 2000 was a year of great challenges and promising opportunities.

It was a year of numerous accomplishments, strategic decisions and forward-looking investments for Department 56. We continued our industry leadership in creative development and product innovation, improved our operations and made significant strides in strengthening our customer base, all of which were designed to establish the sustained profitability of our company in the years ahead.

2000 also proved to be a difficult financial year for our company. As we have previously communicated, our results were impacted by a number of one-time costs and charges associated with the systems implementation problems that carried over from 1999 including a special Customer Appreciation Discount and additional reserve charges. Moreover, a weak December 2000 at retail, wavering consumer confidence and an uncertain outlook for the economy in general are key contributors to a slow and disappointing start for 2001.

The true test of a company comes in its response to tough times. Our plan to attack these challenges is swift, reasoned and proactive. We have already begun to implement this plan designed to redefine our strategy, realign our organization and set us back on a path of growth and enhanced profitability. This plan is rooted in a clear, powerful and achievable vision for the future: to be the most vibrant, enduring, efficient and attentive company in the business. This is a vision that will guide us into the future, and one that will translate into measurable value for our customers, colleagues and shareholders.

To realize the value of our vision, we have expanded our objectives and set our sights on four key strategic initiatives: energizing our core channel, developing new revenue, maximizing consumer growth and advancing our operational excellence.

ENERGIZING OUR CORE CHANNEL Our independent retail network consists of thousands of gift, specialty and collectibles stores, many of which are individual or small chain locations owned and managed by people with a true heart and passion for their business and our products. These loyal retailers stand at the heart of our business, and a key element of our strategic plan is to strengthen our support of these Department 56 champions.

Our key strategy for energizing our core channel is to listen to our retailers throughout the country, study their businesses and deliver practical, concrete tools, information and services that help them operate even more successfully. Our goal is to serve them so that they, in turn, may effectively serve their customers – our consumers.

One support tool is our WIN™ (Web Information Network™) site, established exclusively for our retailers, which allows for easy and effective tracking of order, shipment and invoicing information, online product information and ordering, merchandising ideas and sales associate training. Within this year, we will add several more important features to this tool that will expand its usefulness for our retailers and enhance the relationship that we both have with our consumers.

Further steps taken to strengthen our support for our retailers include the changes that we have made to our sales force organization. We have increased the number of sales representatives and reduced the size of their sales territories, fostering closer relationships between the sales reps and the retailers they serve. Coupled with the assistance that our WIN tools bring to the sales process, these adjustments allow our experienced sales force to focus on using their skills to serve as consultants to our retailers and expanding the distribution of our giftware lines in our core channel.

DEVELOPING NEW REVENUE Our 25-year history has demonstrated our successful formula in creativity, marketing and distribution. What began as six handcrafted buildings blossomed into a thriving multi-million dollar, multiple product line business. Our core collectible lines have given us a leading presence in the industry, and our innovative product development provides a fresh new look in giftware and home décor every year. Department 56 has always been a leader in creative expansion of the marketplace, and our strategic plan builds upon this strength – even as we retain the strength of our core offerings, and find new consumers to enjoy them.

We are committed to maximizing the future profitability of our core collectible lines, and continued limited distribution of these lines is consistent with this commitment. To accomplish this goal, we are establishing a specialty retail program aimed at smaller retailers and non-traditional gift stores that fit our target profile, but face space or consumer-base limitations that would inhibit their full participation in our retail programs. Under our new program, such retailers may carry a smaller number of items than would normally be required. This strategy will not only give us the ability to reach new consumers in certain downtown, urban and less populated rural areas with our exciting products, but correspondingly seeks to create new collectors who undoubtedly will search out traditional full-service retailers to expand their purchases.

In the coming year, we will expand our product lines across more seasons, holidays and recurring events. Tradition and holidays are becoming ever more important as a way to bring family and friends together. This togetherness is the essence of Department 56. During our 25-year history, our tradition of collecting, gift-giving and decorating for the holidays has grown to the point that our products are a part of the fabric of our consumers' lives. Just as the warmth of our Christmas product lines separates us from the rest of our industry, our recent foray into creating spooky fun and ghoulish excitement with our Halloween line has been met with tremendous success. The strength of these products and lines will provide a solid foundation as we roll out new items for new occasions.

Our revenue initiatives also entail both “vertical” and “horizontal” channel expansion. By deepening our penetration in our existing channels with continuity products – line extensions geared toward new consumers as well as lines that encourage series purchases – we seek to drive growth in our existing retail base. At the same time, we will work to extend our brand awareness into new channels, as we have done with our Hot Properties™ lines in major bookstores and upscale toy stores. This initiative allows us to bring new consumers into our circle of offerings and provides a catalyst for profitable growth. This strategy of leveraging the profitability of our existing distribution channels while exploring opportunities for new distribution channels is one that positions us for future revenue development.

MAXIMIZING CONSUMER GROWTH We are, by industry classification, a consumer-products company. This means we must do more than build and deliver great products. To be successful, we must continually heighten the experience of our consumers, capture their passions and command their loyalty.

Our initiatives for consumer-led growth are driven by exhaustive consumer research into purchase motivations, segmentation, and early identification of desired products and features to drive product development and selection. Our consumers are passionate about our products, and to serve them, we must be just as passionate. Department 56's two company-owned retail stores in Minneapolis and Las Vegas, and our planned opening at Downtown Disney® in Anaheim in April of this year, not only serve to build brand recognition, expose our products to new consumers and drive traffic to our existing independent retailers but also function to give us further insight into the key products and display techniques that appeal to our consumers. This crucial information can then be used to help both us and our retailers improve the way in which we create the retail experience. Our consumers, and what they want, will show us the way.

Our consumer communication strategies will continue to support our channel and brand expansion. Further enhancements to our consumer Web site, Department56.com, which already receives over 5 million visits per month, will be designed to create even more enthusiasm among both casual and avid followers. Our objective this year is to double our consumer e-mail list, which currently has over 85,000 voluntarily participants. This important platform enhances our communications efforts and solidifies our brand experience in the minds and hearts of our consumers.

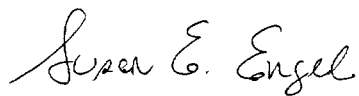
ADVANCING OUR OPERATIONAL EXCELLENCE Our key goal is to meet (and exceed!) our customers' needs – spoken and unspoken – every time we interact with them. In light of this goal, the operational excellence initiative implies two things: delivering continuous improvement in customer experience and driving productivity, efficiency, margin and cost reduction across all aspects of our business. In practice, these are interrelated goals. For instance, more efficient distribution yields faster delivery times and a reduction in the number of shipments per order. These efficiencies, in turn, improve our customers' experiences and build our brand, which in turn decreases the costs associated with customer service, acquisition and retention.

In summary, these initiatives will result in improved customer experiences – and renewed brand loyalty. Together, great product, customer service, Web-enabled access, marketing outreach, and field and showroom sales support, when fully developed across all touch points, will be aimed to serve as an integrated engine of growth and profit for our company.

THE CHALLENGES THAT LIE AHEAD Despite the longevity that we have experienced, the giftware industry faces continual change, as consumer tastes and trends are constantly shifting at an increased rate and consolidation in the retail sector continues. Only companies that understand how to capitalize on change will win, and our company has the vision and strength to succeed. The Board of Directors and management of our company know that continued success and profitability is the result of superior products and superior people. We are fortunate – Department 56 has both. We wish to recognize the dedication of our colleagues, the loyalty of our customers and the encouragement of our stockholders. We are dedicated to justifying their faith through greater achievements in the years ahead. As we affirm the commitments of the people throughout Department 56, we also note with profound sorrow the recent deaths of Brian Little and Nick Forstmann, two of the founding members of our Board of Directors, who were pillars of support to the company and its management.

Our anniversary year is a time for celebration of all we have achieved together in the past 25 years. And in the challenging fiscal environment, it also promises to be a watershed year – a key turning point in the evolution of our company. Our optimism for the future is founded not only on a firm belief in our corporate vision, in the strength of our superior creative and product development capabilities, and of our proven marketing expertise, but most importantly in all of the loyal, hard-working members of the Department 56 family and our partners throughout the world who work with us to bring life to our ideas. I am confident that we have what it takes to make the next 25 years the best ever.

Sincerely,



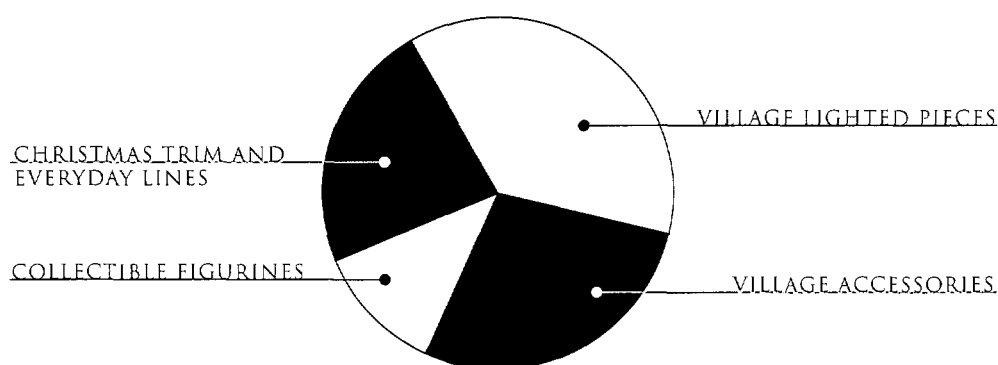
Susan E. Engel
Chairwoman and Chief Executive Officer

ABOUT DEPARTMENT 56

Department 56, Inc. is a leading collectibles and giftware company known for its lighted Villages, Snowbabies™ figurines and extensive lines of holiday and home decorative products. We sell our products primarily through gift, specialty and department store retailers in the United States, Canada and Europe.

Department 56 currently offers more than 4,000 products of which almost half are new in 2001. Our annual product introductions and retirements create continuity and vitality among our core product lines.

2000 PRODUCT DISTRIBUTION



FINANCIAL HIGHLIGHTS

(Dollars in thousands, except per share amounts)

| | 2000 | 1999 | 1998 |
|------------------------------|------------|------------|------------|
| OPERATIONS: | | | |
| Net Sales | \$234,058 | \$255,528 | \$251,153 |
| Income from Operations | 44,884 | 75,366 | 81,009 |
| EBITDA | 55,920 | 84,853 | 88,717 |
| Net Income | 20,793 | 42,656 | 46,516 |
| Net Income per Share | 1.47 | 2.45 | 2.45 |
| YEAR END DATA: | | | |
| Working Capital | \$ 65,581 | \$ 32,289 | \$ 29,276 |
| Total Assets | 277,808 | 287,108 | 233,283 |
| Total Debt | 105,000 | 102,500 | 20,000 |
| Stockholders' Equity | 140,575 | 152,924 | 178,735 |
| Number of Shares Outstanding | 12,824,426 | 15,161,755 | 18,023,335 |

**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, 2000

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 _____ to _____.

Commission file number 1-11908

DEPARTMENT 56, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

13-3684956
(I.R.S. Employer
Identification No.)

One Village Place
6436 City West Parkway
Eden Prairie, MN
(Address of principal executive offices)

55344
(Zip Code)

(952) 944-5600

(Registrant's telephone number, including area code)

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

| <i>Title of each class</i> | <i>Name of each exchange on which registered</i> |
|---|--|
| 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 ☒ 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 \$111,489,536 as of March 22, 2001 (based on the closing price of consolidated trading in the Common Stock on that date as published in *Yahoo! Finance*). 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 22, 2001: 12,881,813.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Company's definitive Proxy Statement for the 2001 Annual Meeting of Stockholders filed with the Securities and Exchange Commission concurrently with this Form 10-K (the "2001 Proxy Statement") are incorporated by reference in Part III.

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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 incorporated in Delaware in 1992 to hold the equity of a Minnesota corporation formed in 1984 under the name "Department 56, Inc.," which has since changed its name to "D 56, Inc." and has continued as the Company's principal operating subsidiary.

The Company seeks complementary businesses that reinforce synergies, allow it to supplement its internal product development, and accelerate its penetration into new markets and new channels. In this connection, in the first quarter of fiscal year 2000 the Company completed a \$4.0 million strategic minority investment in 2-Day Designs, Inc., a manufacturer and marketer of high quality accent furniture and wooden accessories sold primarily through furniture, home furnishings, and catalog retailers. The Company's focused, multi-faceted strategy is intended to position Department 56 as the premier giftware and collectibles company for the future.

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 scenes. The Company introduces new lit pieces, limited edition pieces, figurines and other accessories each year to complement and provide continuity to 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, manufacturing considerations and, importantly, injecting an element of surprise.

Village Accessories – Department 56 also produces a range of accessories for its villages, including figurines, vehicles, landscaping, 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® collectible figurines, Candle Crown™ candle extinguishers, Secret Boxes™, Christmas, Easter, Halloween, and non-seasonal decorative items, tableware, decorative tins, acrylics, "teddy bears" and other "plush" items, 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. Candle Crown candle extinguishers and Secret Boxes, introduced in 2000, provide new product categories to the North American gift and collectible marketplace which enable continuity purchases. 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 4,100 stock keeping units, of which approximately 3,400 are General Giftware products.

Customers:

The Company's principal customers (accounting for approximately 90% of its sales) are approximately 15,000 independent gift retailers across the United States. These retailers include approximately 1,600 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. Approximately 10% of the Company's sales are made to department stores and mail order houses. No single account represented more than 3% of the Company's sales in fiscal 2000. The Company provides volume discounts to its customers with respect to most of its products. The Company has generally had only limited sales outside the United States. International sales were less than 3% of the Company's sales in fiscal 2000.

As part of the Company's strategy of selective distribution, only approximately 5,500 retailers receive the Company's Village Series and/or Snowbabies products. Certain of the Company's lit Village Series products and porcelain Snowbabies figurines have been sold on allocation. The Company periodically evaluates and adjusts its distribution network, and reviews its policies with a view of optimizing both the Company's distribution strategy and the store-level operations of its independent retailers. While the Company remains committed to selective distribution for the Village Series and Snowbabies products, the Company plans to continue to seek complimentary retailers (at times, with a less-than-full offering of the Company's product assortment) to maintain sufficient market presence to accelerate consumer awareness and interest.

Marketing and Advertising:

Department 56 sells its products through nine corporate showrooms and three independently operated wholesale showrooms which cover the major giftware market areas in the United States and Canada. 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 has also launched its business-to-business extranet ("WIN" or Web Information Network) in order to develop greater operational efficiencies and merchandising effectiveness for the Company and its retailers in the future. In addition, the Company sells through giftware trade shows throughout the United States and Canada. During 2000, the Company opened a retail store in the Desert Passage retail complex at Aladdin Casino and Resort in Las Vegas, Nevada. During 2001 the Company plans to open its third store at Downtown Disney®, a retail and entertainment complex located next to the Disneyland® theme park in Anaheim, California. The Company will continue to consider the creation of additional corporately owned stores during 2001 to increase the visibility of the brand and

cultivate consumer awareness. Tests have been conducted of product sales through home television shopping, direct mail, Internet-based retailers and corporate gift programs. 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 trade shows and brochures, and provides merchandising and product information to its collectible product dealers through a newsletter and WIN. It advertises to consumers through brochures, point-of-sale information and seasonal advertisements in magazines and newspapers, and booth presence at major collectibles expos. 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 *Fifty-Six*[™], a quarterly consumer-oriented magazine which contains product-related articles and description of its product lines, and maintains an interactive consumer information center on an Internet web site (www.department56.com). Department 56 maintains a toll-free telephone line for collector questions and participates in collector conventions. The Company also operates a collectors' club to which consumers of its Snowbabies product line may subscribe for exclusive product offerings and information.

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 design 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 yield criteria.

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 The People's Republic of China, Taiwan (Republic of China) and The Philippines. The Company also imports a small percentage of its products from sources in India, and occasionally from sources in Europe (primarily Germany, England, Poland and Czechoslovakia). During fiscal 2000, the Company imported products from approximately 190 independent manufacturing sources, some of which are represented by independent trading companies. The Company's single largest manufacturing source represented approximately 18% of the Company's imports in fiscal 2000. The Company's emphasis on high-quality craftsmanship at affordable prices limits the sources from which the Company chooses to obtain products. The Company has long-standing relationships with the majority of its manufacturers (many for 15 years or more) and often purchases (typically on a year-to-year basis) 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 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 12 months, although the Company continues to investigate processes intended to reduce this time. 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 resin.

Distribution and Systems:

The products sold by the Company in the United States and Canada are generally shipped by ocean freight from abroad and then by rail to the Company's distribution center, located within the northwest quadrant of the Minneapolis/St. Paul metropolitan area. Shipments from the Company to its customers are handled primarily by United Parcel Service or commercial trucking lines.

The Company's systems maintain 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, computer and communication software systems allow on-line information access between the Company's headquarters and its showrooms, and those systems generally provide direct linkage with the Company's field salesforce. These systems also provide a range of order and product information and ordering capabilities to customers subscribing to WIN.

Backlog and Seasonality:

The Company receives products, pays its suppliers and ships products throughout the year, although the majority of shipments historically have occurred 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, 2000, Department 56 had unfilled wholesale orders of approximately \$4.6 million compared to \$5.4 million at January 1, 2000. All of the backlog is scheduled to be shipped to customers during the current fiscal year. Approximately 7% to 8% of the Company's total annual customer orders have been cancelled in each of the last three years for a number of reasons, but primarily due to inventory shortages and customer credit considerations.

Department 56 historically has experienced 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 approximately 64% to 65% 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 and first quarters. 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 and first quarters. 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 has historically recorded a substantial portion of its revenues in its second and third quarters.

Trademarks and Other Proprietary Rights:

The Company owns 32 U.S. trademark registrations and has pending U.S. trademark applications 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 U.S. registrations for the Company's trademarks are currently scheduled to expire or be cancelled at

various times between 2002 and 2010, 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, mass market and specialty chain stores, televised home shopping networks, internet commerce 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. These elements, as well as presence in large, category-leading retail chains, also apply in the home décor marketplace. 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, have 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 The People's Republic of China, Taiwan and The Philippines. The Company also imports a small percentage of its products from sources in India, and occasionally from sources in Europe (primarily Germany, England, Poland and Czechoslovakia).

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. The Company is subject to the following risks inherent in foreign manufacturing: fluctuations in currency exchange rates; economic and political instability; cost fluctuations and delays in transportation; restrictive actions by foreign governments; nationalizations; the laws and policies of the U.S. affecting importation of goods (including duties, quotas and taxes); and foreign trade and tax laws. In particular, the Company's costs could be adversely affected if the currencies of other countries in which the Company sources product appreciate significantly relative to the U.S. dollar.

Substantially all of the Company's products are subject to customs 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 U.S. 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 increase, or the mix of countries from which it sources its products may change, in the future if countries that are currently accorded "Normal Trade Relations" status by the United States cease to have such status or the United States imposes retaliatory duties against imports from such countries. The Company cannot predict what regulatory changes may occur or the type or amount of any financial impact on the Company such changes may have in the future.

In fiscal 2000, approximately 83% (as compared to approximately 76% in fiscal 1999) of the Company's imports were manufactured in The People's Republic of China, which is accorded "Normal Trade Relations" status on a temporary basis 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 or suggested by The People's Republic of China in relation to Taiwan, are under review by the United States government and, accordingly, the duty treatment of goods imported from The People's Republic of China is subject to political uncertainties. To the extent The People's Republic of China may cease to have "Normal Trade Relations" status or its exports may be subject to political retaliation, the cost of importing products from such country would increase significantly, and the Company believes that there could be a short-term adverse effect on the Company until alternative manufacturing arrangements were obtained. If the current effort of the People's Republic of China to accede to the World Trade Organization is successful prior to the current deadline set for June 2001, a yearly Congressional review and vote on the Normal Trade Relations status of China will no longer take place and China will have such status on a continuing basis.

Employees:

As of February 20, 2001, the Company had 328 full-time employees in the United States, eight in Canada and one in Taiwan. Of the total workforce, approximately 100 are engaged in wholesale sales representation throughout North America and 14 are associated with the Company's corporate-owned retail properties. The Company's 66 U.S.-based warehouse, shipping and receiving personnel employed as of that date are represented by Local Union No. 638 of the Teamsters under a contract that expires on December 31, 2001. The Company will begin the process of negotiating a new contract in fiscal 2001. 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 that the Company cannot now predict.

ITEM 2. PROPERTIES

The Company owns or leases buildings that contain approximately 639,000 square feet of floor space. The Company's primary corporate showroom, executive offices and creative center are located in Eden Prairie, Minnesota. During 2000, the Company entered into lease agreements for two corporate-owned stores. The office building in Eden Prairie, Minnesota is owned by the Company and the remainder of the Company's facilities are leased. The following table identifies each of the facilities utilized by the Company's operations.

| <i>Facility</i> | <i>Location</i> | <i>Lease Expiration Date</i> | <i>Approximate Number of Square Feet</i> |
|--|------------------|----------------------------------|--|
| Executive Offices, Creative Center and Primary Corporate Showroom | Eden Prairie, MN | Company-owned facility | 66,400 |
| Warehouse and Distribution Facility | Rogers, MN | 6-30-2010 | 333,700 |
| Warehouse and Distribution Facility | Bloomington, MN | 2-28-2002 | 159,000 |
| Showroom | Atlanta, GA | 12-31-2006 | 12,946 |
| Showroom | Chicago, IL | 11-30-2006 | 7,480 |
| Showroom | Dallas, TX | 1-31-2007 | 9,143 |
| Showroom | Los Angeles, CA | 12-31-2002 | 6,600 |
| Showroom | Minnetonka, MN | 10-31-2007 | 5,144 |
| Showroom | New York, NY | 12-31-2005 | 10,300 |
| Showroom | Fairfax, VA | 12-31-2003 | 4,300 |
| Showroom | Bedford, MA | 6-30-2004 | 1,800 |
| Showroom | Columbus, OH | 5-31-2009 | 2,485 |
| Retail store | Bloomington, MN | 4-30-2009 | 10,200 |
| Retail store | Las Vegas, NV | 10-31-2010 | 3,100 |
| Retail store | Anaheim, CA | 3-31-2012 | 6,250 |

ITEM 3. LEGAL PROCEEDINGS

The Company is involved in various legal proceedings, claims and governmental audits in the ordinary course of its business.

On September 14, 2000, Arthur Andersen LLP filed a lawsuit against the Company in The Fourth Judicial District, State of Minnesota alleging breach of contract in connection with computer system implementation work and seeking \$0.6 million plus interest and legal costs. On March 1, 2001, the Company filed suit in The Circuit Court of Baltimore City, State of Maryland against Andersen Worldwide Société Coopérative and W. Robert Grafton alleging fraud, conspiracy, tortuous conduct and breach of contract in connection with the computer systems implementation work solicited and performed by Arthur Andersen LLP and seeking \$1 billion in compensatory damages, plus punitive damages and legal costs.

On March 5 and March 9, 2001 lawsuits seeking unspecified compensatory damages were filed against the Company and its Chairwoman and Chief Executive Officer Susan E. Engel, in the United States District Court for the District of Minnesota purportedly on behalf of the class of persons who purchased Department 56 common stock during the period February 24, 1999 through April 26, 2000. The purported class action lawsuits allege the Company and its Chairwoman violated federal securities laws by making a series of false and misleading statements concerning the Company's financial statements. The Company intends to defend these lawsuits vigorously.

The Company believes it has meritorious defenses to all proceedings, claims and audits. Management is unable however to predict the ultimate outcome of these proceedings, claims and audits or to reasonably estimate the impact, if any, that the ultimate resolution of these matters will have on the Company's results of operations, financial position or cash flows.

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, 2000.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Department 56's common stock is currently traded on the New York Stock Exchange ("NYSE") under the symbol "DFS." The table below sets forth the high and low sales prices as reported by the NYSE.

| | <i>High</i> | <i>Low</i> |
|----------------|-------------|------------|
| FISCAL 2000 | | |
| First quarter | 23.69 | 12.88 |
| Second quarter | 15.69 | 7.44 |
| Third quarter | 14.94 | 8.75 |
| Fourth quarter | 15.88 | 10.00 |
| FISCAL 1999 | | |
| First quarter | 37.88 | 29.44 |
| Second quarter | 33.31 | 24.50 |
| Third quarter | 29.00 | 23.63 |
| Fourth quarter | 24.81 | 18.31 |

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.

As of March 22, 2001, the number of holders of record of the Company's Common Stock was 854.

ITEM 6. SELECTED FINANCIAL DATA

FIVE-YEAR SUMMARY (In thousands, except per share amounts)

YEARS ENDED DECEMBER 30, 2000, JANUARY 1, 2000, JANUARY 2, 1999, JANUARY 3, 1998, AND DECEMBER 28, 1996

The following selected consolidated financial data should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations, and the Consolidated Financial Statements and related Notes thereto, included elsewhere herein.

| | December 30, 2000 ¹ | January 1, 2000 ¹ | January 2, 1999 ¹ | January 3, 1998 ¹ | December 28, 1996 ¹ |
|--|-----------------------------------|---------------------------------|---------------------------------|---------------------------------|-----------------------------------|
| STATEMENTS OF INCOME | | | | | |
| Net sales ² | \$234,058 | \$255,528 | \$251,153 | \$225,566 | \$233,988 |
| Cost of sales ² | <u>109,522</u> | <u>113,475</u> | <u>108,570</u> | <u>100,110</u> | <u>100,403</u> |
| Gross profit | 124,536 | 142,053 | 142,583 | 125,456 | 133,585 |
| Operating expenses: | | | | | |
| Selling, general and administrative | 74,166 | 61,542 | 56,648 | 49,772 | 47,853 |
| Amortization of goodwill, trademarks and other intangibles | <u>5,486</u> | <u>5,145</u> | <u>4,926</u> | <u>4,577</u> | <u>4,577</u> |
| Total operating expenses | <u>79,652</u> | <u>66,687</u> | <u>61,574</u> | <u>54,349</u> | <u>52,430</u> |
| Income from operations | 44,884 | 75,366 | 81,009 | 71,107 | 81,155 |
| Other expense (income): | | | | | |
| Interest expense | 11,729 | 6,719 | 4,817 | 4,362 | 6,063 |
| Gain on sale of aircraft ³ | — | — | — | (2,882) | — |
| Other, net | <u>(382)</u> | <u>(153)</u> | <u>(397)</u> | <u>(1,086)</u> | <u>(648)</u> |
| Income before income taxes | 33,537 | 68,800 | 76,589 | 70,713 | 75,740 |
| Provision for income taxes | <u>12,744</u> | <u>26,144</u> | <u>30,073</u> | <u>27,932</u> | <u>29,796</u> |
| Net income | \$ 20,793 | \$ 42,656 | \$ 46,516 | \$ 42,781 | \$ 45,944 |
| Net income per common share – basic | \$ 1.47 | \$ 2.48 | \$ 2.49 | \$ 2.06 | \$ 2.13 |
| Net income per common share – assuming dilution | \$ 1.47 | \$ 2.45 | \$ 2.45 | \$ 2.05 | \$ 2.11 |
| BALANCE SHEET DATA | | | | | |
| Working capital | \$ 65,581 | \$ 32,289 | \$ 29,276 | \$ 40,857 | \$ 67,997 |
| Total assets | 277,808 | 287,108 | 233,283 | 259,695 | 285,733 |
| Total debt | 105,000 | 102,500 | 20,000 | 40,000 | 60,000 |
| Total stockholders' equity ⁴ | 140,575 | 152,924 | 178,735 | 186,655 | 196,757 |

¹ The years ended December 28, 1996, January 2, 1999, January 1, 2000 and December 30, 2000 were 52-week periods, and the year ended January 3, 1998, was a 53-week period.

² Net sales and cost of sales have each been increased as a result of reclassifying outgoing freight costs in order to comply with the requirements of Emerging Issues Task Force Issue Number 00-10, Accounting for Shipping and Handling Fees and Costs. Such expenses were formerly classified as a reduction of net sales. This change has no impact on gross profit amounts. Outgoing freight costs totaled \$9,069, \$9,672, \$7,788, \$6,070, and \$5,213, for the years ended December 30, 2000, January 1, 2000, January 2, 1999, January 3, 1998 and December 28, 1996, respectively.

³ During December 1997, the Company exercised its purchase option under an aircraft lease agreement and subsequently sold the aircraft at its appraised value to a former officer of the Company for \$8,567, recognizing a gain of \$2,882.

⁴ 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.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

(In millions, except per share amounts)

The following discussion of the results of operations and financial condition should be read in conjunction with the Department 56, Inc. Consolidated Financial Statements and related Notes thereto, included elsewhere herein.

| | 2000 | | 1999 | | 1998 | |
|--|---------|-------------------------|---------|-------------------------|---------|-------------------------|
| | Dollars | Percent of Net Sales | Dollars | Percent of Net Sales | Dollars | Percent of Net Sales |
| Net sales ¹ | \$234.1 | 100% | \$255.5 | 100% | \$251.2 | 100% |
| Gross profit | 124.5 | 53 | 142.1 | 56 | 142.6 | 57 |
| Selling, general and administrative expenses | 74.2 | 32 | 61.5 | 24 | 56.6 | 23 |
| Amortization of goodwill, trademarks and other intangibles | 5.5 | 2 | 5.2 | 2 | 4.9 | 2 |
| Income from operations | 44.9 | 19 | 75.4 | 29 | 81.0 | 32 |
| Interest expense | 11.7 | 5 | 6.7 | 3 | 4.8 | 2 |
| Other, net | (.4) | — | (.2) | — | (.4) | — |
| Income before income taxes | 33.5 | 14 | 68.8 | 27 | 76.6 | 30 |
| Provision for income taxes | 12.7 | 5 | 26.1 | 10 | 30.1 | 12 |
| Net income | 20.8 | 9 | 42.7 | 17 | 46.5 | 19 |
| Net income per common share assuming dilution | 1.47 | | 2.45 | | 2.45 | |
| Operating cash flow ² | 55.9 | | 84.9 | | 88.7 | |

¹ Net sales have been increased as a result of reclassifying outgoing freight costs in order to comply with the requirements of Emerging Issues Task Force Issue Number 00-10, Accounting for Shipping and Handling Fees and Costs. Such expenses were formerly classified as a reduction of net sales. This change has no impact on gross profit amounts. Outgoing freight costs totaled \$9.1 million, \$9.7 million, and \$7.8 million for the years ended December 30, 2000, January 1, 2000, and January 2, 1999, respectively.

² Operating cash flow represents earnings before interest, income taxes, depreciation and amortization. Operating cash flow is used by management and certain investors as an indicator of a company's historical ability to service debt. However, operating cash flow is not intended to represent cash flow from operations for the period, nor has it been presented as an alternative to either (i) operating income (as determined by GAAP) as an indicator of operating performance or (ii) cash flow from operating, investing and financing activities (as determined by GAAP). Operating cash flow is, therefore, susceptible to varying calculations and, as presented, may not be comparable to other similarly titled measures of other companies.

COMPARISON OF RESULTS OF OPERATIONS 2000 TO 1999

Net Sales – Net sales decreased \$21.4 million, or 8%, from \$255.5 million in 1999 to \$234.1 million in 2000. The decrease in sales was principally due to a decrease in sales volume of approximately \$12.6 million, or 5%, the impact of a customer appreciation discount that the Company offered on orders taken during the first quarter of 2000 of approximately \$6.3 million, or 2%, and an increase in the amount provided for returned product. The increase in the amount provided for returned product was primarily the result of a \$6.5 million charge taken during the first quarter of 2000. The offer of the customer appreciation discount to affirm returning customer relationships and the \$6.5 million charge taken for returned product were each a result of the problems experienced during the implementation of the Company's new enterprise-wide information system beginning in early 1999, as previously communicated. Sales of Village Series products decreased \$17.9 million, or 11%, while sales of General Giftware products decreased \$3.5 million, or 4% between the two periods. Village Series products represented 65% of the Company's sales in 2000 versus 67% in 1999.

Gross Profit – Gross profit as a percentage of net sales was 56% and 53% in 1999 and 2000, respectively. Excluding the impact of the customer appreciation discount and the increase in the amount provided for returned product, gross profit as a percent of sales would have been 56% during both 1999 and 2000.

Selling, General and Administrative Expenses – Selling, general and administrative expenses increased \$12.6 million, or 21%, between 1999 and 2000. The increase is principally due to an increase in the amount provided for bad debts, an increase in depreciation and expenses related to the Company's continued investment in information systems and its new distribution center, an increase in expenses related to the Company's launching of its new business-to-business extranet, and an increase in other administrative expenses. The increase in the provision for bad debts was primarily due to a \$5.5 million charge taken during the first quarter of 2000 as a result of the problems experienced during the implementation of the Company's new enterprise-wide information system beginning in early 1999, as previously communicated. These increases were principally offset by a decrease in marketing expense, a decrease in commission expense, and a decrease in the write-off of acquisition costs. Selling, general and administrative expenses as a percentage of sales was 24% and 32% during 1999 and 2000, respectively. Excluding the impact of the customer appreciation discount and increased provisions for returned product and bad debts, selling, general and administrative expenses as a percentage of sales would have been 28% in 2000.

Income from Operations – Income from operations decreased \$30.5 million, or 40%, from 1999 to 2000 due to the factors described above. Operating margins decreased from 29% of net sales in 1999 to 19% of net sales in 2000. Excluding the impact of the customer appreciation discount and the increased provisions for returned product and bad debts, income from operations would have been 26% of net sales in 2000.

Interest Expense – Interest expense increased \$5.0 million, or 75%, between 1999 and 2000 principally due to increased borrowings under the Company's credit facilities in 2000 and increased interest rates paid by the Company. Additional borrowings were required as a result of slower cash collections and share repurchases.

Provision for Income Taxes – The effective income tax rate was 38.0% during 1999 and 2000.

COMPARISON OF RESULTS OF OPERATIONS 1999 TO 1998

Net Sales – Net sales increased \$4.3 million, or 2%, from \$251.2 million in 1998 to \$255.5 million in 1999. The increase in sales was principally due to an increase in sales volume, offset partially by an increase in the amount provided for returned product. Sales of Village Series products increased 5% from 1998 to 1999, while General Giftware product sales decreased 6% during the same period. Village Series products represented 67% of the Company's sales in 1999 versus 65% in 1998.

Gross Profit – Gross profit decreased \$0.5 million, or less than 1%, between 1998 and 1999. Gross profit as a percentage of sales decreased from 57% in 1998 to 56% in 1999, principally due to an increase in the amount provided for returned product.

Selling, General and Administrative Expenses – Selling, general and administrative expenses increased \$4.9 million, or 9%, between 1998 and 1999. The increase is principally due to a 31% increase in distribution expenses, a 12% increase in marketing expenses and a 2% increase in administrative expenses. The increase in distribution expense was principally due to a \$0.9 million charge related to the Company's consolidation of its two current distribution centers and a storage facility into one new

distribution center in 2000, and a 63% increase in temporary labor due to the shipping difficulties experienced as a result of the implementation of the Company's new integrated computer system. The increase in administrative expenses is principally due to an increase in bad debt expense, the write-off of failed acquisition costs, an increase in showroom expense as a result of the Company's acquisition of showrooms during 1999 and 1998, an increase in depreciation expense associated with the implementation of the integrated computer system, and expenses associated with the operation of the Company's first retail store. These increases were principally offset by a decrease in commission expense due to the acquisition of showrooms, a decrease in bonus expense and a decrease in other administrative expenses. Selling, general and administrative expenses as a percentage of sales was 23% and 24% during 1998 and 1999, respectively.

Income from Operations – Income from operations decreased \$5.6 million, or 7%, from 1998 to 1999 due to the factors described above. Operating margins decreased from 32% of net sales in 1998 to 29% of net sales in 1999.

Interest Expense – Interest expense increased \$1.9 million, or 40%, between 1998 and 1999 principally due to increased borrowings under the revolving credit agreement. Additional borrowings were required as a result of slower cash collections which were impacted by the timing and manner in which invoices, shipping documents and statements were mailed to customers as a result of the implementation of the new integrated computer system. Additional borrowings were also required due to increased capital expenditures.

Provision for Income Taxes – The effective income tax rate was 39.3% and 38.0% during 1998 and 1999, respectively.

SEASONALITY

Historically, principally due to the timing of wholesale trade shows early in the calendar year and the limited supply of the Company's products, the Company has received the majority of its total annual customer orders during the first quarter of each year. The Company entered 64% and 65% of its total annual customer orders during 2000 and 1999, respectively, during the first quarter of each of those years. Cancellations of total annual customer orders were approximately 7% and 8% in 2000 and 1999, respectively.

The Company shipped and recorded as net sales (net of returns, allowances and cash discounts), approximately 91% of its annual customer orders during both 2000 and 1999. Orders not shipped in a particular year, net of cancellations, are carried into backlog for the following year and have historically been orders for Spring and Easter products. The Company's backlog was \$4.6 million and \$5.4 million at December 30, 2000 and January 1, 2000, respectively.

The Company receives products, pays its suppliers and ships products throughout the year, although historically the majority of shipments occur in the second and third quarters as retailers stock merchandise in anticipation of the holiday season. As a result of this seasonal pattern, the Company generally records its highest sales during the second and third quarters of each year. As a result of this historical pattern, 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 consistent with the Company's business strategy.

| | 2000 | | | | | 1999 | | | | |
|---|----------|----------|----------|----------|---------|----------|----------|----------|----------|---------|
| | 1st Qtr. | 2nd Qtr. | 3rd Qtr. | 4th Qtr. | Total | 1st Qtr. | 2nd Qtr. | 3rd Qtr. | 4th Qtr. | Total |
| Customer orders entered ¹ | \$165.1 | \$51.3 | \$34.5 | \$ 7.3 | \$258.2 | \$182.3 | \$47.7 | \$39.9 | \$11.4 | \$281.3 |
| Net sales ² | 43.0 | 60.0 | 72.0 | 59.1 | 234.1 | 34.5 | 85.7 | 78.4 | 56.9 | 255.5 |
| Gross profit | 21.4 | 33.5 | 40.3 | 29.3 | 124.5 | 19.9 | 49.2 | 44.1 | 28.8 | 142.1 |
| Selling, general and administrative expenses | 23.2 | 16.1 | 16.2 | 18.7 | 74.2 | 12.5 | 16.5 | 16.5 | 16.1 | 61.5 |
| Amortization of goodwill, trademarks and other intangibles | 1.4 | 1.4 | 1.4 | 1.4 | 5.5 | 1.3 | 1.3 | 1.3 | 1.3 | 5.2 |
| (Loss) income from operations | (3.1) | 16.1 | 22.7 | 9.2 | 44.9 | 6.2 | 31.5 | 26.3 | 11.4 | 75.4 |
| Net (loss) income | (3.2) | 8.3 | 12.0 | 3.6 | 20.8 | 3.3 | 18.7 | 15.0 | 5.6 | 42.7 |
| Net (loss) income per common share assuming dilution ³ | (0.21) | 0.58 | 0.85 | 0.28 | 1.47 | 0.18 | 1.04 | 0.87 | 0.35 | 2.45 |

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

² Net sales have been increased as a result of reclassifying outgoing freight costs in order to comply with the requirements of Emerging Issues Task Force Issue Number 00-10, Accounting for Shipping and Handling Fees and Costs. Such expenses were formerly classified as a reduction of net sales. This change has no impact on gross profit amounts. Outgoing freight costs totaled \$2.6 million, \$2.3 million, \$2.1 million, and \$2.1 million for the quarters ended April 1, 2000, July 1, 2000, September 30, 2000, and December 30, 2000, respectively. During 1999, outgoing freight costs totaled \$0.8 million, \$3.0 million, \$3.3 million, and \$2.6 million for the quarters ended April 3, 1999, July 3, 1999, October 2, 1999, and January 1, 2000, respectively.

³ See Note 11 to the Consolidated Financial Statements.

LIQUIDITY AND CAPITAL RESOURCES

The Company's credit agreement provides for a revolving credit facility and a term loan facility. The revolving credit facility provides for borrowings of up to \$100 million including letters of credit. The letters of credit are issued primarily in connection with inventory purchases. The credit agreement contains numerous financial and operating covenants, including restrictions on incurring indebtedness and liens, selling property and paying dividends. In addition, the Company is required to satisfy consolidated net worth, interest coverage ratio and leverage ratio tests, in each case at the end of each fiscal quarter. None of these restrictions are expected to have a material adverse effect on the Company's ability to operate in the future.

During the first quarter of 2000, the Company borrowed an additional \$90 million of term debt under its term loan facility which brought the total outstanding term debt to \$150 million as of April 1, 2000. During the second quarter of 2000, the Company prepaid \$45 million of term debt which can not be re-borrowed and included the \$22.5 million payment due March 2001. During the first quarter of 2001, the Company prepaid \$20 million of term debt under its current credit facility. As of March 14, 2001, the total term debt outstanding was \$85 million. The Company's remaining term debt requires annual amortization payments of \$0.9 million, \$32.4 million, and \$51.7 due March 2002, 2003 and 2004, respectively.

The Company believes that its internally generated cash flow and seasonal borrowings under the revolving credit facility will be adequate to fund operations and capital expenditures for the next 12 months.

Consistent with customary practice in the giftware industry, the Company offers extended accounts receivable terms to many of its customers. This practice has typically created significant working capital requirements in the second and third quarters which the Company has generally financed with available

cash, internally generated cash flow and seasonal borrowings. The Company's cash and cash equivalents balances peak during the first quarter of the subsequent year, following the collection of accounts receivable with extended payment terms due in November and December.

Accounts receivable decreased from \$65.6 million at January 1, 2000 to \$37.0 million at December 30, 2000. The decrease in accounts receivable was principally due to a decrease in sales and an unusually high balance of accounts receivable open at the end of 1999. Cash collections in 1999 were lower than normal due to the problems experienced in 1999 related to the implementation of the Company's enterprise-wide information system, as previously communicated. Accounts receivable at December 30, 2000 were approximately \$10.0 million higher than comparable periods at the end of 1997 and 1998, primarily due to slower cash collections from some of the Company's retail customers stemming from a generally weak 2000 holiday season. Management believes there is adequate provision for any doubtful accounts receivable and sales returns that may arise.

Capital expenditures were \$7.1 million, \$16.3 million, and \$6.8 million for 2000, 1999 and 1998, respectively. During 2000, capital expenditures related to the Company's new distribution facility, the Company's second retail store, and the launch of its business-to-business extranet totaled \$2.3 million, \$1.1 million and \$2.0 million, respectively. Included in 1999 and 1998 capital expenditures is \$7.7 million and \$4.1 million, respectively, incurred in connection with the Company's implementation of its integrated computer system. During 1999, capital expenditures related to the Company's new distribution facility and the Company's first retail store totaled \$5.7 million and \$2.0 million, respectively.

During 2000, the Company completed a \$4.0 million strategic minority investment in 2-Day Designs, Inc., a manufacturer and marketer of high quality accent furniture and wooden accessories sold primarily through furniture, home furnishings, and catalog retailers principally in the United States. The transaction is accounted for under the equity method of accounting.

During 1999, the Company acquired substantially all of the assets of the independent sales representative organizations that represented the Company's products in Massachusetts and several other eastern states, Minnesota and several other midwestern states and Texas and several surrounding southern states. The cost of these acquisitions was \$4.0 million.

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

The impact of these acquisitions on the Company's results of operations are not considered significant.

In April 1999, the Company executed a lease for a new distribution center in Minnesota. The lease provides for a 10-year term, with options to renew the lease, as well as to expand and/or acquire the facility. During 2000, the Company consolidated its two current distribution centers and storage facility into the new distribution center. Estimated costs of \$0.9 million were recorded in 1999 related to noncancelable lease contracts associated with the existing rented facilities.

Operating cash flow, defined as earnings before interest, income tax, depreciation, and amortization expenses, decreased \$29.0 million, or 34%, from \$84.9 million in 1999 to \$55.9 million in 2000. The decrease was principally due to the decrease in net income.

The Company has a stock repurchase program. Under the program, the Company repurchased 2.4 million shares during 2000 at an average price of \$14 per share. Since January 1997, the Company has repurchased a total of 9.2 million shares at an average price of \$24 per share. As of December 30, 2000, the Company had remaining authorization from the Board of Directors to repurchase \$52.4 million of its stock through 2001. The timing, prices and amounts of shares repurchased, as well as the manner of execution, will be determined at the discretion of the Company's management and subject to continued compliance with the Company's credit facilities.

ACCOUNTING CHANGES

To conform with the requirements of the Emerging Issues Task Force ("EITF") Issue No. 00-10, *Accounting for Shipping and Handling Fees and Costs*, the Company reclassified freight expenses for products shipped to customers into cost of products sold. Such expenses were formerly classified as a reduction of net sales. This change has no impact on previously reported gross profit amounts or net earnings.

In December 1999, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin ("SAB") No. 101, *Revenue Recognition in Financial Statements*. SAB No. 101 summarized the SEC's view in applying generally accepted accounting principles to selected revenue recognition issues. Adoption of SAB No. 101 did not have a material effect on the Company's consolidated financial position or results of operations for 2000.

On December 31, 2000 (fiscal year 2001), the Company adopted Statement of Financial Accounting Standard ("SFAS") No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*. SFAS No. 133 establishes accounting and reporting standards for derivative instruments and for hedging activities. It requires that all derivatives, including those embedded in other contracts, be recognized as either assets or liabilities and that those financial instruments be measured at fair value. The accounting for changes in the fair value of derivatives depends on their intended use and designation. Management has reviewed the requirements of SFAS No. 133 and has determined that they have no free-standing or embedded derivatives. All contracts that contain provisions meeting the definition of a derivative also meet the requirements of, and have been designated as, normal purchases or sales.

FOREIGN EXCHANGE

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

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

EFFECT OF INFLATION

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

FACTORS AFFECTING FUTURE EARNINGS

On February 22, 2001, the Company issued a press release stating in relevant part: "Retail customer orders through February 17 are down approximately 35% against the comparable period in the prior year. Village orders are approximately 40% below the comparable period in the prior year, while General Giftware orders are down approximately 24%." The press release also noted, "We are clearly feeling the impact of a slow December and an overall holiday selling season that was significantly below the increase for which retailers had planned. The combination of this erosion in consumer confidence across the whole economy and our proven ability to fulfill reorders which come in after the first quarter has caused many retailers to take a wait-and-see approach. While we cannot project how orders will come in through the remainder of the year, we may see more reorder activity than we have in the past resulting in a shift in our order patterns. Our informal discussions with approximately seven hundred-fifty of our retailers and more in-depth discussions with a small but representative sample of this group lead us to believe that we may experience upside order potential from our current run rate."

The press release further stated: "The largest gap in our orders is from collectible accounts that have not yet ordered. Our informal survey through our sales force leads us to believe that over ninety percent of these missing accounts are planning to order. Of the small number not planning to order, the vast majority have been closing stores as would be expected in a rotation of channel entries and exits..."

Ms. Engel continued, "In light of year-to-date orders being substantially below our internal expectations, our focus during the balance of 2001 will be on identifying and pursuing new revenue opportunities, driving reorders and maximizing earnings and cash flow by closely managing costs and capital investments."

On Form 8-K dated February 23, 2001, the Company stated: "The Company's orders through February 17, 2001 from retail accounts that fit the Company's definition of a Like Account were down 21% relative to the full first quarter of 2000. Like Accounts are considered those accounts, excluding Department Store accounts, whose total orders through February 17, 2001 were greater than one third of their total orders for the full first quarter of 2000."

On March 5 and March 9, 2001 lawsuits seeking unspecified compensatory damages were filed against the Company and its Chairwoman and Chief Executive Officer. See Item 3, Legal Proceedings.

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

The Company's expectations regarding 2001 are based on the Company's expectations for sales and operating margin. The Company's sales expectations for 2001 are based on the Company's current forecast of retailer orders and planned sales through its retail arm, and is further dependent on the

timing and extent of promotional and marketing efforts undertaken by the Company as well as the timing and extent of product receipts and shipments, the efficiency of information systems developed to collect, compile and execute customer orders, and retailer and consumer demand. Retailer orders have principally been dependent on the amount, quality and market acceptance of the new product introductions and retailer demand, but order patterns have historically varied in number, mix and timing, and there can be no assurance that the year-to-date order levels or trends will not deteriorate, or that they will exhibit levels or trends supportive of a shift toward greater orders later in the year. Moreover, the Company's order forecasting model is dependent on assumptions concerning retail inventory levels, consumer demand, and retailer expectations. The Company's operating margin may be impacted by, amongst other factors, shifts in product mix and/or gross margin, exchange rate fluctuations with countries the Company imports from, changes in freight rates and changes in the Company's historical selling, general and administrative expense rate, including bad debts.

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

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Information required by this Item is included in Management's Discussion and Analysis on page 10, and Note 1 to the Consolidated Financial Statements.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

See Consolidated Financial Statements on page F-1 herein.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information required by this Item is included in the 2001 Proxy Statement in the sections captioned “*Item 1 – Election of Directors – Nominees for Terms Ending at the 2002 Annual Meeting of Stockholders*” and “*Biographical Information Regarding Executive Officers,*” and such information is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

Information required by this Item is included in the 2001 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 and Stock Incentive 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 2001 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

See Note 9 to the Consolidated Financial Statements on page F-13.

PART IV

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

The Exhibits, and other documents filed as part of this Annual Report on Form 10-K, including those exhibits which are incorporated by reference herein, are:

| | <i>Page</i> |
|---|-------------|
| (a) 1. <i>Financial Statements</i> | |
| Independent Auditors' Report | F-1 |
| Consolidated Balance Sheets as of December 30, 2000 and January 1, 2000 | F-2 |
| For the years ended December 30, 2000, January 1, 2000 and January 2, 1999: | |
| Consolidated Statements of Income | F-3 |
| Consolidated Statements of Cash Flows | F-4 |
| Consolidated Statements of Stockholders' Equity | F-5 |
| Notes to Consolidated Financial Statements | F-6 |
| 2. <i>Financial Statement Schedule</i> | |
| II. Valuation and Qualifying Accounts | S-1 |
| All other schedules have been omitted because they are not applicable. | |
| 3. <i>Exhibits</i> | |

Exhibits required in connection with this Annual Report on Form 10-K are listed below.

| <i>Exhibit</i> | <i>Description</i> |
|----------------|---|
| 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. SEC File No. 1-11908.) |
| 3.2 | Certificate of Designation, Preferences and Rights of Series A Junior Participating Preferred Stock of the Company. (Incorporated herein by reference to Exhibit 1.1 of Registrant's Amendment No. 1, dated May 12, 1997, to Registration Statement on Form 8-A, dated April 23, 1997. SEC File No. 1-11908.) |
| 3.3 | 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. SEC File No. 1-11908.) |
| 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. SEC File No. 1-11908.) |
| 4.2 | Rights Agreement (including Exhibits A, B and C thereto), dated as of April 23, 1997, between the Company and ChaseMellon Shareholder Services, L.L.C., as Rights Agent. (Incorporated herein by reference to Exhibit 1 of Registrant's Registration Statement on Form 8-A, dated April 23, 1997. SEC File No. 1-11908.) |
| 4.3 | First Amendment, dated as of March 13, 1998, to Rights Agreement between the Company and ChaseMellon Shareholder Services, L.L.C., as Rights Agent. (Incorporated herein by reference to Exhibit 1 to Registrant's Amendment No. 2, dated March 16, 1998, to Registration Statement on Form 8-A, dated April 23, 1997. SEC File No. 1-11908.) |
| 4.4 | Amendment No. 2 to Rights Agreement, dated as of February 25, 1999, between the Company and ChaseMellon Shareholder Services, L.L.C., as Rights Agent. (Incorporated herein by reference to Exhibit 99.2 of Registrant's Current Report on Form 8-K dated February 26, 1999. SEC File No. 1-11908.) |
| 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 10.3 of Registrant's Annual Report on Form 10-K for the fiscal year ended January 3, 1998. SEC File No. 1-11908.)† |

| <i>Exhibit</i> | <i>Description</i> |
|----------------|---|
| 10.4 | Lease Agreement dated April 14, 1999 between D 56, Inc. and Ryan Companies US, Inc. pertaining to the Rogers warehouse and distribution facility. (Incorporated herein by reference to Exhibit 10.4 of Registrant's Annual Report on Form 10-K for the fiscal year ended January 1, 2000. SEC File No. 1-11908.) |
| 10.5 | Guaranty of Lease dated April 14, 1999 between the Company and Ryan Companies US, Inc. pertaining to the Rogers warehouse and distribution facility. (Incorporated herein by reference to Exhibit 10.5 of Registrant's Annual Report on Form 10-K for the fiscal year ended January 1, 2000. SEC File No. 1-11908.) |
| 10.6 | Credit Agreement, dated as of March 19, 1999 among the Company, the Banks parties thereto, ABN Amro Bank N.V. and The First National Bank of Chicago, as documentation agents, U.S. Bank National Association, as managing agent, and The Chase Manhattan Bank, as administrative agent. (Incorporated herein by reference to Exhibit 10.7 of Registrant's Annual Report on Form 10-K for the fiscal year ended January 2, 1999. SEC File No. 1-11908.) |
| 10.7 | First Amendment to the Credit Agreement, dated as of January 27, 2000 among the Company, the Banks parties thereto, ABN Amro Bank N.V. and Bank One NA, as documentation agents, U.S. Bank National Association, as managing agent, and The Chase Manhattan Bank, as administrative agent. (Incorporated herein by reference to Exhibit 10.7 of Registrant's Annual Report on Form 10-K for the fiscal year ended January 1, 2000. SEC File No. 1-11908.) |
| 10.8 | Guarantee and Collateral Assignment, dated as of March 19, 1999, by the Company and certain of its direct or indirect subsidiaries in favor of The Chase Manhattan Bank. (Incorporated herein by reference to Exhibit 10.8 of Registrant's Annual Report on Form 10-K for the fiscal year ended January 2, 1999. SEC File No. 1-11908.) |
| 10.9 | 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.) |
| 10.10 | 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.)† |
| 10.11 | Department 56, Inc. 1995 Stock Incentive Plan. (Incorporated herein by reference to Exhibit 10.18 of Registrant's Annual Report on Form 10-K for the fiscal year ended December 30, 1995. SEC File No. 1-11908.)† |
| 10.12 | Department 56, Inc. 1997 Stock Incentive Plan. (Incorporated herein by reference to Exhibit 4.4 of Registrant's Registration Statement on Form S8, No. 33341639.)† |
| 10.13 | Form of Executive Stock Option Agreement in connection with Department 56, Inc. 1993 Stock Incentive Plan, Department 56, Inc. 1995 Stock Incentive Plan, and Department 56, Inc. 1997 Stock Incentive Plan. (Incorporated herein by reference to Exhibit 10.13 of Registrant's Annual Report on Form 10-K for the fiscal year ended January 1, 2000. SEC File No. 1-11908.)† |
| 10.14 | Form of Performance – Accelerated Vesting Stock Option Agreement in connection with Department 56, Inc. 1993, 1995 and 1997 Stock Incentive Plans.†* |
| 10.15 | Form of Executive Performance Share Agreement in connection with Department 56, Inc. 1993, 1995 and 1997 Stock Incentive Plans. (Incorporated herein by reference to Exhibit 10.14 of Registrant's Annual Report on Form 10-K for the fiscal year ended January 1, 2000. SEC File No. 1-11908.)† |
| 10.16 | Department 56, Inc. Annual Cash Incentive Program. (Incorporated herein by reference to Exhibit 10.25 of Registrant's Annual Report on Form 10-K for the fiscal year ended January 3, 1998. SEC File No. 1-11908.)† |
| 21.1 | Subsidiaries of the Company.* |
| 23.1 | Independent Auditors' Consent.* |

† *Management contract or compensatory plan.*

* *Filed herewith.*

(b) Reports on Form 8-K

No reports on Form 8-K were filed during the fourth quarter of the year ended December 30, 2000.

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.

Date: March 30, 2001

By: /s/ SUSAN E. ENGEL

Susan E. Engel
*Chairwoman of the Board
and Chief Executive Officer*

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.

| <i>Signature</i> | <i>Capacity in which signed</i> | <i>Date</i> |
|---|---|----------------|
| <u>/s/ SUSAN E. ENGEL</u> Susan E. Engel | Chairwoman of the Board, Chief Executive Officer and Director (Principal Executive Officer) | March 30, 2001 |
| <u>/s/ PERCY C. TOMLINSON, JR.</u> Percy C. Tomlinson, Jr. | Chief Financial Officer and Executive Vice President (Principal Financial Officer) | March 30, 2001 |
| <u>/s/ GREGG A. PETERS</u> Gregg A. Peters | Director of Finance and Principal Accounting Officer (Principal Accounting Officer) | March 30, 2001 |
| <u>/s/ PETER K. BARKER</u> Peter K. Barker | Director | March 30, 2001 |
| <u>/s/ JAY CHIAT</u> Jay Chiat | Director | March 30, 2001 |
| <u>/s/ STEWART M. KASEN</u> Stewart M. Kasen | Director | March 30, 2001 |
| <u>/s/ GARY S. MATTHEWS</u> Gary S. Matthews | Director | March 30, 2001 |
| <u>/s/ STEVEN G. ROTHMEIER</u> Steven G. Rothmeier | Director | March 30, 2001 |
| <u>/s/ VIN WEBER</u> Vin Weber | Director | March 30, 2001 |

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, 2000 and January 1, 2000 and the related consolidated statements of income, cash flows, and stockholders' equity for the years ended December 30, 2000, January 1, 2000, and January 2, 1999. Our audit also included the financial statement schedule listed in the Index at Item 14. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated 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 as of December 30, 2000 and January 1, 2000 and the results of its operations and its cash flows for the years ended December 30, 2000, January 1, 2000, and January 2, 1999 in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

Deloitte & Touche LLP

Minneapolis, Minnesota

February 22, 2001

except for Note 4 and Note 12, as to which the date is March 14, 2001

Department 56, Inc. and Subsidiaries**CONSOLIDATED BALANCE SHEETS***(In thousands, except per share amounts)**AS OF DECEMBER 30, 2000 AND JANUARY 1, 2000*

| | 2000 | 1999 |
|---|------------------|------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 23,698 | \$ 3,962 |
| Accounts receivable, net of allowances of \$19,591 and \$18,287, respectively | 36,994 | 65,580 |
| Inventories | 15,650 | 15,901 |
| Deferred taxes | 10,104 | 9,448 |
| Other current assets | 3,638 | 4,751 |
| Total current assets | 90,084 | 99,642 |
| PROPERTY AND EQUIPMENT, net | 31,796 | 29,857 |
| GOODWILL, net of accumulated amortization of \$34,402 and \$30,096, respectively | 135,034 | 139,340 |
| TRADEMARKS AND OTHER INTANGIBLES, net of accumulated amortization of \$5,030 and \$4,009, respectively | 15,575 | 16,596 |
| OTHER ASSETS | 5,319 | 1,673 |
| | <u>\$277,808</u> | <u>\$287,108</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Borrowings on revolving credit agreement | \$ — | \$ 42,500 |
| Accounts payable | 7,866 | 9,709 |
| Commissions payable | 190 | 513 |
| Other current liabilities | 16,447 | 14,631 |
| Total current liabilities | 24,503 | 67,353 |
| DEFERRED TAXES | 7,730 | 6,831 |
| LONG-TERM DEBT | 105,000 | 60,000 |
| 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 21,990 and 21,964 shares, respectively | 220 | 220 |
| Additional paid-in capital | 50,019 | 49,845 |
| Treasury stock, at cost; 9,166 and 6,802 shares, respectively | (216,636) | (183,320) |
| Retained earnings | 306,972 | 286,179 |
| Total stockholders' equity | 140,575 | 152,924 |
| | <u>\$277,808</u> | <u>\$287,108</u> |

See notes to consolidated financial statements.

Department 56, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share amounts)

YEARS ENDED DECEMBER 31, 2000, JANUARY 1, 2000, AND JANUARY 2, 1999

| | 2000 | 1999 | 1998 |
|--|------------------|------------------|------------------|
| NET SALES | \$234,058 | \$255,528 | \$251,153 |
| COST OF SALES | <u>109,522</u> | <u>113,475</u> | <u>108,570</u> |
| Gross profit | 124,536 | 142,053 | 142,583 |
| OPERATING EXPENSES: | | | |
| Selling, general and administrative | 74,166 | 61,542 | 56,648 |
| Amortization of goodwill, trademarks and other intangibles | <u>5,486</u> | <u>5,145</u> | <u>4,926</u> |
| Total operating expenses | <u>79,652</u> | <u>66,687</u> | <u>61,574</u> |
| INCOME FROM OPERATIONS | 44,884 | 75,366 | 81,009 |
| OTHER EXPENSE (INCOME): | | | |
| Interest expense | 11,729 | 6,719 | 4,817 |
| Other, net | <u>(382)</u> | <u>(153)</u> | <u>(397)</u> |
| INCOME BEFORE INCOME TAXES | 33,537 | 68,800 | 76,589 |
| PROVISION FOR INCOME TAXES | <u>12,744</u> | <u>26,144</u> | <u>30,073</u> |
| NET INCOME | <u>\$ 20,793</u> | <u>\$ 42,656</u> | <u>\$ 46,516</u> |
| NET INCOME PER COMMON SHARE | <u>\$ 1.47</u> | <u>\$ 2.48</u> | <u>\$ 2.49</u> |
| NET INCOME PER COMMON SHARE ASSUMING DILUTION | <u>\$ 1.47</u> | <u>\$ 2.45</u> | <u>\$ 2.45</u> |

See notes to consolidated financial statements.

Department 56, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

YEARS ENDED DECEMBER 30, 2000, JANUARY 1, 2000, JANUARY 2, 1999

| | 2000 | 1999 | 1998 |
|---|------------------|-----------------|-----------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income | \$ 20,793 | \$ 42,656 | \$ 46,516 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation | 5,168 | 4,189 | 2,385 |
| Amortization of goodwill, trademarks and other intangibles | 5,486 | 5,145 | 4,926 |
| Amortization of deferred financing fees | 382 | 269 | — |
| Deferred taxes | 243 | (1,836) | (629) |
| Changes in assets and liabilities: | | | |
| Accounts receivable | 28,586 | (39,410) | (3,166) |
| Inventories | 251 | 2,386 | 186 |
| Other assets | 926 | (2,607) | (961) |
| Accounts payable | (1,843) | (1,391) | 1,127 |
| Commissions payable | (323) | (2,549) | (893) |
| Other current liabilities | 1,926 | 990 | 2,582 |
| Net cash provided by operating activities | 61,595 | 7,842 | 52,073 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Purchases of property and equipment | (7,109) | (16,345) | (6,750) |
| Acquisitions | (4,000) | (3,970) | (4,660) |
| Net cash used in investing activities | (11,109) | (20,315) | (11,410) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Proceeds from the exercise of common stock options | 66 | 1,170 | 2,846 |
| Borrowings on revolving credit agreement | 64,500 | 94,500 | 75,500 |
| Principal payments on revolving credit agreement | (107,000) | (52,000) | (75,500) |
| Purchases of treasury stock | (33,316) | (70,018) | (58,087) |
| Proceeds from issuance of long-term debt | 90,000 | 40,000 | — |
| Principal payments on long-term debt | (45,000) | — | (20,000) |
| Net cash (used in) provided by financing activities | (30,750) | 13,652 | (75,241) |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 19,736 | 1,179 | (34,578) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD | 3,962 | 2,783 | 37,361 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | <u>\$ 23,698</u> | <u>\$ 3,962</u> | <u>\$ 2,783</u> |

See notes to consolidated financial statements.

Department 56, Inc. and Subsidiaries

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In thousands)

YEARS ENDED DECEMBER 30, 2000, JANUARY 1, 2000, AND JANUARY 2, 1999

| | <u>Common Stock</u> | | <u>Additional</u> | <u>Treasury</u> | <u>Retained</u> | <u>Total</u> |
|---|---------------------|---------------|-------------------|--------------------|------------------|----------------------|
| | <u>Shares</u> | <u>Amount</u> | <u>Paid-in</u> | <u>Stock</u> | <u>Earnings</u> | <u>Stockholders'</u> |
| | | | <u>Capital</u> | | | <u>Equity</u> |
| BALANCE AS OF JANUARY 3, 1998 | 19,566 | \$218 | \$44,645 | \$ (55,215) | \$197,007 | \$186,655 |
| Net income | | | | | 46,516 | 46,516 |
| Shares issued upon the exercise of common stock options | 131 | 1 | 3,541 | | | 3,542 |
| Shares repurchased | (1,677) | | | (58,087) | | (58,087) |
| Other | <u>3</u> | <u>—</u> | <u>109</u> | <u>—</u> | <u>—</u> | <u>109</u> |
| BALANCE AS OF JANUARY 2, 1999 | 18,023 | 219 | 48,295 | (113,302) | 243,523 | 178,735 |
| Net income | | | | | 42,656 | 42,656 |
| Shares issued upon the exercise of common stock options | 60 | 1 | 1,439 | | | 1,440 |
| Shares repurchased | (2,925) | | | (70,018) | | (70,018) |
| Other | <u>4</u> | <u>—</u> | <u>111</u> | <u>—</u> | <u>—</u> | <u>111</u> |
| BALANCE AS OF JANUARY 1, 2000 | 15,162 | 220 | 49,845 | (183,320) | 286,179 | 152,924 |
| Net income | | | | | 20,793 | 20,793 |
| Shares issued upon the exercise of common stock options | 20 | | 81 | | | 81 |
| Shares repurchased | (2,364) | | | (33,316) | | (33,316) |
| Other | <u>6</u> | <u>—</u> | <u>93</u> | <u>—</u> | <u>—</u> | <u>93</u> |
| BALANCE AS OF DECEMBER 30, 2000 | <u>12,824</u> | <u>\$220</u> | <u>\$50,019</u> | <u>\$(216,636)</u> | <u>\$306,972</u> | <u>\$140,575</u> |

See notes to consolidated financial statements.

Department 56, Inc. and Subsidiaries

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share amounts)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Business – The Company is engaged in the original design, importation, and wholesale distribution of specialty giftware products. The majority of the Company's products are developed and designed by the Company's in-house creative team and are manufactured for the Company by independently owned foreign manufacturers located primarily in the Pacific Rim. The Company's customer base and accounts receivable are primarily composed of, and are due from, retail stores of various sizes located throughout the United States and Canada. Less than 3% of total revenue is derived from customers outside the United States and less than 1% of all long-lived assets are located outside the United States. No customer represents more than 3% of total revenue in any period presented. Retail revenues represented less than 2% of total 2000 revenues.

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

Fiscal Year End – The Company's policy is to end its fiscal year on the Saturday closest to December 31. The years ended December 30, 2000, January 1, 2000 and January 2, 1999 include 52 weeks.

Cash Equivalents – All highly liquid debt instruments with original maturities of three months or less are considered to be cash equivalents.

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 adjusts identified, unsalable and slow-moving inventory to its net realizable value.

Long-Lived Assets – The Company's policy is to review long-lived assets for impairment when events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. If impairment indicators are present and the estimated future undiscounted cash flows are less than the carrying value of the assets and any related goodwill, the carrying value is reduced to the estimated fair value as measured by the discounted cash flows.

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 2 to 45 years.

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

Goodwill – 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 20 to 40 years.

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

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

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

Freight Expense – Freight expenses for products shipped to customers (“freight-out”) are included in cost of products sold, in accordance with Emerging Issues Task Force Issue No. 00-10, *Accounting for Shipping and Handling Fees and Costs*. Such expenses were formerly reported as a reduction of net sales. Prior period freight-out expenses have been reclassified to cost of products sold, which had no effect on previously reported gross profit amounts or net income.

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.

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

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. There were no forward currency contracts outstanding at December 30, 2000 and January 1, 2000.

Net Income per Common Share – Net income per common share is calculated by dividing net income by the weighted average number of shares outstanding during the period. Net income per

common share assuming dilution reflects per share amounts that would have resulted had the Company's outstanding stock options been converted to common stock. See Note 11.

Management Estimates – The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 – On December 31, 2000, the Company adopted Statement of Financial Accounting Standard ("SFAS") No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*. SFAS No. 133 establishes accounting and reporting standards for derivative instruments and for hedging activities. It requires that all derivatives, including those embedded in other contracts, be recognized as either assets or liabilities and that those financial instruments be measured at fair value. The accounting for changes in the fair value of derivatives depends on their intended use and designation. Management has reviewed the requirements of SFAS No. 133 and has determined that they have no free-standing or embedded derivatives. All contracts that contain provisions meeting the definition of a derivative also meet the requirements of, and have been designated as, normal purchases or sales. Currently, the Company does not use free-standing derivatives and has not entered into contracts with terms that cannot be designated as normal purchases or sales.

2. PROPERTY AND EQUIPMENT

Property and equipment at December 30, 2000 and January 1, 2000 is comprised of the following:

| | 2000 | 1999 |
|-------------------------------|-----------------|-----------------|
| Leasehold improvements | \$ 6,199 | \$ 6,519 |
| Furniture and fixtures | 4,761 | 4,239 |
| Computer equipment | 19,205 | 15,560 |
| Other equipment | 6,179 | 8,735 |
| Building | 7,045 | 6,896 |
| Land | 906 | 906 |
| | <u>44,295</u> | <u>42,855</u> |
| Less accumulated depreciation | 12,499 | 12,998 |
| Property and equipment, net | <u>\$31,796</u> | <u>\$29,857</u> |

3. OTHER CURRENT LIABILITIES

Other current liabilities at December 30, 2000 and January 1, 2000 are comprised of the following:

| | 2000 | 1999 |
|-----------------------------------|-----------------|-----------------|
| Accrued compensation and benefits | \$ 6,212 | \$ 3,581 |
| Income taxes payable | 6,795 | 8,411 |
| Deferred revenue | 662 | 694 |
| Accrued royalty fees | 1,421 | 818 |
| Other | 1,357 | 1,127 |
| | <u>\$16,447</u> | <u>\$14,631</u> |

4. CREDIT AGREEMENT

Long-term debt at December 30, 2000 and January 1, 2000 is comprised of the following:

| | 2000 | 1999 |
|---------------------------------------|------------------|------------------|
| Total debt | \$105,000 | \$102,500 |
| Less borrowings classified as current | <u>—</u> | <u>42,500</u> |
| | <u>\$105,000</u> | <u>\$ 60,000</u> |

The Company's credit agreement provides for a revolving credit facility and a term loan facility. During the first quarter of 2000, the Company borrowed an additional \$90 million of term debt under its term loan facility which brought the total outstanding term debt to \$150 million as of April 1, 2000. During the second quarter of 2000, the Company prepaid \$45 million of term debt which can not be re-borrowed and included the \$22.5 million payment due March 2001. During the first quarter of 2001, the Company prepaid \$20 million of term debt under its current credit facility. As of March 14, 2001, the total term debt outstanding was \$85 million. The Company's remaining term debt requires annual amortization payments of \$0.9 million, \$32.4 million, and \$51.7 due March 2002, 2003 and 2004, respectively.

The revolving line of credit provides for borrowings of up to \$100 million, which may be in the form of letters of credit, bankers' acceptances, and revolving credit loans. The letters of credit are issued primarily in connection with inventory purchases. The revolving line of credit includes a clean-down provision whereby the Company's revolving credit loans and bankers' acceptances may not exceed an aggregate of \$30 million during any one 30-consecutive-day period beginning November 1 and ending March 31. Borrowings under the credit agreement are subject to certain borrowing base limitations (as defined). The revolving line of credit provides for commitment fees of 0.25% to 0.50% per annum on the daily average of the unused commitment.

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

The credit agreement includes restrictions as to, among other things, the amount of additional indebtedness, liens, contingent obligations, investments and dividends. Under the most restrictive of these covenants, approximately \$278,000 of retained earnings were restricted at December 30, 2000.

The credit agreement also requires maintenance of minimum levels of interest coverage, net worth and maximum levels of leverage. None of these restrictions are expected to have a material adverse effect on the Company's ability to operate in the future.

The Company has pledged the common stock of its subsidiaries, direct and indirect, as collateral under the credit agreement and the Company and its subsidiaries, direct and indirect, have guaranteed repayment of amounts borrowed under the credit agreement.

The Company paid interest of \$10,933, \$8,023, and \$4,859 during the years ended December 30, 2000, January 1, 2000, and January 2, 1999, respectively.

5. INCOME TAXES

The provision for income taxes for the years ended December 30, 2000, January 1, 2000, and January 2, 1999 consisted of the following:

| | 2000 | 1999 | 1998 |
|----------|-----------------|-----------------|-----------------|
| Current: | | | |
| Federal | \$11,423 | \$25,427 | \$28,188 |
| State | 979 | 2,180 | 2,416 |
| Foreign | 99 | 373 | 98 |
| Deferred | 243 | (1,836) | (629) |
| | <u>\$12,744</u> | <u>\$26,144</u> | <u>\$30,073</u> |

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

| | 2000 | 1999 | 1998 |
|--|-----------------|-----------------|-----------------|
| Income taxes at federal statutory rate | \$11,738 | \$24,080 | \$26,806 |
| State income taxes, net of federal income tax deductions | 508 | 1,033 | 1,915 |
| Goodwill amortization | 1,448 | 1,448 | 1,448 |
| Other | (950) | (417) | (96) |
| Provision for income taxes | <u>\$12,744</u> | <u>\$26,144</u> | <u>\$30,073</u> |

The components of the net deferred tax asset at December 30, 2000 and January 1, 2000 were as follows:

| | 2000 | 1999 |
|-------------------------------------|-----------------|-----------------|
| DEFERRED TAX ASSETS: | | |
| Asset valuation allowances | \$ 9,509 | \$ 8,416 |
| Deferred compensation | 376 | 286 |
| Accrued liabilities | 414 | 730 |
| Other | <u>1,001</u> | <u>564</u> |
| Total deferred tax assets | 11,300 | 9,996 |
| DEFERRED TAX LIABILITIES: | | |
| Trademark amortization | (5,399) | (5,569) |
| Property and equipment depreciation | (3,187) | (1,667) |
| Other | <u>(340)</u> | <u>(143)</u> |
| Total deferred tax liabilities | <u>(8,926)</u> | <u>(7,379)</u> |
| | <u>\$ 2,374</u> | <u>\$ 2,617</u> |

The \$2,374 net deferred tax asset at December 30, 2000 is presented as a net deferred current asset of \$10,104 and a net deferred noncurrent liability of \$7,730. The \$2,617 net deferred tax asset at January 1, 2000 is presented as a net deferred current asset of \$9,448 and a net deferred noncurrent liability of \$6,831.

The Company paid income taxes of \$14,101, \$28,085, and \$29,829 during the years ended December 30, 2000, January 1, 2000, and January 2, 1999, respectively.

6. COMMITMENTS AND CONTINGENCIES

Operating Leases – The Company leases warehouse and office space, equipment, and showroom display facilities under renewable operating leases with remaining terms of up to 11 years. 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, 2000:

| | |
|------------|-----------------|
| 2001 | \$ 4,056 |
| 2002 | 3,792 |
| 2003 | 3,526 |
| 2004 | 3,569 |
| 2005 | 3,608 |
| Thereafter | <u>12,994</u> |
| | <u>\$31,545</u> |

The Company's rental expense was \$3,609, \$3,326, and \$2,533 for the years ended December 30, 2000, January 1, 2000, and January 2, 1999, respectively.

In April 1999, the Company executed a lease for a new distribution center in Minnesota. The lease provides for a 10-year term, with options to renew the lease, as well as to expand and/or acquire the facility. During 2000, the Company consolidated its two current distribution centers and storage

facility into the new distribution center. Estimated costs of \$931 were recorded in 1999 related to noncancelable lease contracts associated with the existing rented facilities.

Letters of Credit – The Company had outstanding standby and commercial letters of credit amounting to \$1,860 at December 30, 2000 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.

The Company believes it has meritorious defenses to all proceedings, claims and audits. Management is unable however to predict the ultimate outcome of these proceedings, claims and audits or to reasonably estimate the impact, if any, that the ultimate resolution of these matters will have on the Company's results of operations, financial position or cash flows. See Note 12.

7. RETIREMENT PLAN

The Company has a qualified contributory retirement plan (the Plan) under Section 401(k) of the Internal Revenue Code which covers substantially all full-time employees who meet certain eligibility requirements. Voluntary contributions are made by participants and Company matching contributions are made at the discretion of the Board of Directors, subject to certain limitations. The Plan also allows the Company to make discretionary profit-sharing contributions to the Plan up to the maximum amount deductible for income tax purposes. The Company's total profit-sharing contributions were \$1,517, \$1,249, and \$1,025 for the years ended December 30, 2000, January 1, 2000, and January 2, 1999, respectively.

8. ACQUISITIONS

During 2000, the Company completed a \$4.0 million strategic minority investment in 2-Day Designs, Inc., a manufacturer and marketer of high quality accent furniture and wooden accessories sold primarily through furniture, home furnishings, and catalog retailers principally in the United States. The transaction is accounted for under the equity method of accounting.

During 1999, the Company acquired substantially all of the assets of the independent sales representative organizations that represented the Company's products in Massachusetts and several other eastern states, Minnesota and several other midwestern states and Texas and several surrounding southern states. The cost of these acquisitions was \$4.0 million.

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

The impact of these acquisitions on the Company's results of operations are not considered significant.

9. RELATED-PARTY TRANSACTIONS

In the ordinary course of business, the Company sells product to a floral and nursery wholesaler and retailer, of which a former director of the Company is an officer, director and stockholder. The Company had sales to this floral and nursery business during the year ended January 2, 1999 of \$1,448.

10. STOCKHOLDERS' EQUITY

Stock-Based Compensation Plans – At December 30, 2000, the Company had four stock-based compensation plans. Under the 1992, 1993, 1995, and 1997 stock option and incentive plans, the Company may grant options to its directors, officers, employees, consultants and advisors of the Company for up to 292,500, 1,000,000, 600,000 and 1,500,000 shares of common stock, respectively. All employee options granted after the initial public offering have an exercise price equal to the market value of the common stock at the date of grant, generally have a term of ten years, and generally are exercisable in equal installments on each of the first, second and third anniversaries of the date of the grant. At December 30, 2000, 221,628 shares were available for granting under the stock option and incentive plans.

A summary of the status of the Company's four stock option and incentive plans as of December 30, 2000, January 1, 2000, and January 2, 1999, and changes during the years ended on those dates is presented below:

| | 2000 | | 1999 | | 1998 | |
|---|--|---------|--|---------|--|---------|
| | Weighted Average Exercise Price | | Weighted Average Exercise Price | | Weighted Average Exercise Price | |
| | Shares | Price | Shares | Price | Shares | Price |
| Outstanding at beginning of year | 2,094,311 | \$26.70 | 1,724,357 | \$26.80 | 1,983,578 | \$26.25 |
| Granted | 693,713 | 12.43 | 458,300 | 25.42 | 97,000 | 31.87 |
| Exercised | – | – | (56,482) | 20.52 | (129,625) | 21.90 |
| Forfeited | (254,443) | 29.81 | (31,864) | 24.77 | (226,596) | 26.94 |
| Outstanding at end of year | <u>2,533,581</u> | 22.54 | <u>2,094,311</u> | 26.70 | <u>1,724,357</u> | 26.80 |
| Options exercisable at end of year | 1,601,921 | 26.22 | 1,446,272 | 27.63 | 1,085,026 | 28.95 |
| Weighted average fair value of options granted during the year | \$ 5.83 | | \$ 12.33 | | \$ 14.89 | |

The Company applies Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for its plans. Accordingly, no compensation cost has been recognized for options granted since the initial public offering. Had compensation cost been determined based on the fair value of the 1998, 1999, and 2000 stock option grants consistent with the method of SFAS 123, *Accounting for Stock-Based Compensation*, the Company's net income

and net income per common share assuming dilution would have been reduced to the pro forma amounts indicated below:

| | 2000 | 1999 | 1998 |
|--|----------|----------|----------|
| Net income: | | | |
| As reported | \$20,793 | \$42,656 | \$46,516 |
| Pro forma | 19,567 | 40,647 | 44,223 |
| Net income per common share – basic: | | | |
| As reported | \$ 1.47 | \$ 2.48 | \$ 2.49 |
| Pro forma | 1.39 | 2.36 | 2.37 |
| Net income per common share – assuming dilution: | | | |
| As reported | \$ 1.47 | \$ 2.45 | \$ 2.45 |
| Pro forma | 1.38 | 2.34 | 2.33 |

In determining the preceding pro forma amounts under SFAS 123, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for grants in 2000, 1999, and 1998, respectively: risk-free interest rates of 6.6 percent, 5.9 percent, and 5.2 percent, expected volatility of 38 percent, expected lives of 6 years and no expected dividends. The effects of applying SFAS 123 in this pro forma disclosure are not indicative of future compensation costs. SFAS 123 does not apply to awards prior to 1995, and additional awards are anticipated.

The following table summarizes information about the Company's stock option and incentive plans at December 30, 2000:

| Range of Exercise Prices | Number Outstanding at December 30, 2000 | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number Exercisable at December 30, 2000 | Weighted Average Exercise Price |
|--------------------------------|--|---|--|--|--|
| \$ 3.33 | 40,500 | 1.1 years | \$ 3.33 | 40,500 | \$ 3.33 |
| 3.34-17.99 | 659,000 | 9.2 | 12.46 | — | — |
| 18.00-21.47 | 962,942 | 6.3 | 20.76 | 868,138 | 20.88 |
| 21.48-37.75 | 871,139 | 5.8 | 33.04 | 693,283 | 34.25 |
| | <u>2,533,581</u> | | | <u>1,601,921</u> | |

In addition to stock options granted under the Company's stock option plans, the Company granted options to purchase 30,000 shares of Common Stock to each of four members of the Company's Board of Directors in December 1992. During February 1993, the Company granted options to purchase 30,000 shares of Common Stock to one member of the Board of Directors. These options are not subject to a stock option plan. Such options are exercisable, have a term of ten years from the date of grant, and have an exercise price of \$3.33 per share. During 2000, 1999 and 1998, members of the Board of Directors exercised 20,000, 3,000, and 2,000 options, respectively. At December 30, 2000, directors' options to purchase 15,000 shares of Common Stock were exercisable at \$3.33 per share.

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

Performance Shares – During 1999, the Company began to grant performance shares to executive officers on an annual basis. The performance shares granted during 1999 were made for overlapping "initial stub" one-year and two-year cycles, as well as a "full cycle" three-year performance period. During 2000, performance shares were granted for a "full cycle" three-year performance period. Each performance share represents one notional common stock equivalent and provides that its holder can receive the market value of up to 1.5 shares of common stock upon the Company's achieving specified diluted earnings per share ("EPS") as measured at the end of the particular performance cycle. Upon achievement of the targeted performance, the Company may choose to pay the award in cash, unrestricted common stock or a combination. During 2000, the Company granted 39,750 shares for the three-year cycle ending 2002. During 1999, the Company granted: 11,500 performance shares for the one-year cycle ended 1999; 23,899 performance shares granted for the two-year cycle ending 2000; and 35,825 performance shares granted for the three-year cycle ending 2001. The Company did not achieve the minimum EPS thresholds for both the one-year and two-year cycles ended 1999 and 2000, respectively, and accordingly no pay-outs were made and those performance shares were cancelled.

11. INCOME PER COMMON SHARE

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

| | 2000 | 1999 | 1998 |
|---|------------|------------|------------|
| Net income | \$ 20,793 | \$ 42,656 | \$ 46,516 |
| Weighted average number of shares outstanding | 14,110,000 | 17,214,000 | 18,676,000 |
| Net income per common share – basic | \$ 1.47 | \$ 2.48 | \$ 2.49 |
| Net income | \$ 20,793 | \$ 42,656 | \$ 46,516 |
| Weighted average number of shares outstanding | 14,110,000 | 17,214,000 | 18,676,000 |
| Dilutive impact of options outstanding | 54,000 | 174,000 | 284,000 |
| Weighted average number of shares and potential dilutive shares outstanding | 14,164,000 | 17,388,000 | 18,960,000 |
| Net income per common share – assuming dilution | \$ 1.47 | \$ 2.45 | \$ 2.45 |

Options to purchase 2,297,381, 914,000 and 662,000 shares of common stock were outstanding at December 30, 2000, January 1, 2000 and January 2, 1999, respectively, but were not included in the computation of net income per common share assuming dilution because the exercise prices were greater than the average market price of the common stock.

12. SUBSEQUENT EVENT

On March 5 and March 9, 2001 lawsuits seeking unspecified compensatory damages were filed against the Company and its Chairwoman and Chief Executive Officer Susan E. Engel, in the United States District Court for the District of Minnesota purportedly on behalf of the class of persons who purchased Department 56 common stock during the period February 24, 1999 through April 26, 2000. The purported class action lawsuits allege the Company and its Chairwoman violated federal securities laws by making a series of false and misleading statements concerning the Company's financial statements. The Company intends to defend these lawsuits vigorously.

The Company believes it has meritorious defenses to these lawsuits. Management is unable however to predict the ultimate outcome of these proceedings, or to reasonably estimate the impact, if any, that the ultimate resolution of these matters will have on the Company's results of operations, financial position or cash flows.

Department 56, Inc. and Subsidiaries
SCHEDULE II
VALUATION AND QUALIFYING ACCOUNTS
(In thousands)

| <i>Column A</i> | <i>Column B</i> | <i>Column C</i> | <i>Column D</i> | <i>Column E</i> |
|---|--|--|-------------------------|--------------------------------------|
| <i>Description</i> | <i>Balance Beginning of Period</i> | <i>Charged to Costs and Expenses</i> | <i>Deductions</i> | <i>Balance End of Period</i> |
| Year ended December 30, 2000: | | | | |
| Allowance for doubtful accounts | \$ 7,659 | \$ 8,476 | \$ 5,652 ^(a) | \$10,483 |
| Allowance for sales returns and credits | 10,628 | 15,986 | 17,506 | 9,108 |
| | <u>\$18,287</u> | <u>\$24,462</u> | <u>\$23,158</u> | <u>\$19,591</u> |
| Year ended January 1, 2000: | | | | |
| Allowance for doubtful accounts | \$ 5,179 | \$ 3,276 | \$ 796 ^(a) | \$ 7,659 |
| Allowance for sales returns and credits | 7,729 | 12,737 | 9,838 | 10,628 |
| | <u>\$12,908</u> | <u>\$16,013</u> | <u>\$10,634</u> | <u>\$18,287</u> |
| Year ended January 2, 1999: | | | | |
| Allowance for doubtful accounts | \$ 5,160 | \$ 888 | \$ 869 ^(a) | \$ 5,179 |
| Allowance for sales returns and credits | 7,897 | 8,657 | 8,825 | 7,729 |
| | <u>\$13,057</u> | <u>\$ 9,545</u> | <u>\$ 9,694</u> | <u>\$12,908</u> |

^(a) Accounts determined to be uncollectible and charged against allowance account, net of collections on accounts previously charged against allowance account.

CORPORATE AND STOCKHOLDER INFORMATION

BOARD OF DIRECTORS

Susan E. Engel^{1,5}
*Chairwoman and
Chief Executive Officer*
Department 56, Inc.

Peter K. Barker^{1,2,3}
Advisory Director
Goldman Sachs & Co.

Jay Chiat³
Chairman
ScreamingMedia.com, Inc.

Stewart M. Kasen³
Private Investor

Gary S. Matthews^{2,5}
*President and Chief
Executive Officer*
Derby Cycle Corporation

Steven G. Rothmeier^{1,2,4}
*Chairman and Chief
Executive Officer*
Great Northern Capital

Vin Weber^{3,4,5}
Partner
Clark & Weinstock Inc.

¹ Member of Executive Committee

² Member of Audit Committee

³ Member of Compensation Committee

⁴ Member of Stock Incentive Committee

⁵ Member of Nominating Committee

OFFICERS

Susan E. Engel
*Chairwoman and
Chief Executive Officer*

David W. Dewey
*Executive Vice President –
Product Development*

Yeh-Huang Lin
Vice President – Overseas Operations

Elise M. Linehan
Vice President – Marketing

Andrew E. Melville
Senior Vice President – Sales

Robert S. Rose
Vice President – Distribution

Timothy J. Schugel
*Senior Vice President – Sourcing
Management and Production Control*

Gregory G. Sorensen
Vice President – Technology

Alan L. Sussman
*Senior Vice President
and Chief Information Officer*

Tom Tomlinson
*Executive Vice President and
Chief Financial Officer*

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

STOCKHOLDER INFORMATION

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

Transfer Agent
Mellon Investor Services LLC
150 North Wacker Drive, Suite 2120
Chicago, IL 60606
1-800-851-9677
www.mellon-investor.com

Independent Auditors
Deloitte & Touche LLP

Stock Listing
New York Stock Exchange
Symbol "DFS"

Annual Meeting
11:00 a.m. Central Time
May 10, 2001
Minnesota World Trade Center
300 Minnesota World Trade Center
30 East Seventh Street
St. Paul, MN

INVESTOR RELATIONS

Additional copies of this 2000 Annual Report and Form 10-K are available without charge by making a written request to Investor Relations at the Company's corporate offices or by calling 952-944-5600.

CONSUMER INFORMATION

The retailer nearest you can be identified by calling our consumer information line at 1-800-LIT-TOWN (1-800-548-8696) or by accessing our Web site at www.department56.com. Our Web site also includes information about our Company, products and employment opportunities.

1976 - 2001

DEPARTMENT



CELEBRATING
50 YEARS OF
TRADITION

One Village Place

City West Parkway

PO BOX 55344

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