1997 ANNUAL REPORT
tradition of growth

Department 56

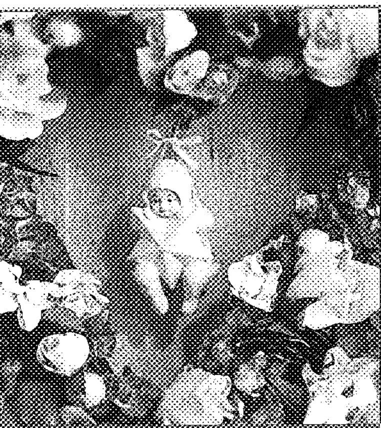
Department 56, Inc.

Department 56, Inc. is a leading fine-quality collectibles and giftware company best known for its popular lighted villages, The Original Snow Village® and The Heritage Village Collection,® and its Snowbabies™ figurines. In addition, Department 56, Inc. offers an extensive line of holiday and decorative products. The company's products are sold through more than 19,000 authorized gift, home accessory, specialty and department store retailers in the U.S. and Canada. Department 56 seeks to expand its market presence through innovative marketing and product development, as well as through partnerships with others. Founded in 1976, Department 56 is based in Eden Prairie, Minnesota.

FINANCIAL HIGHLIGHTS

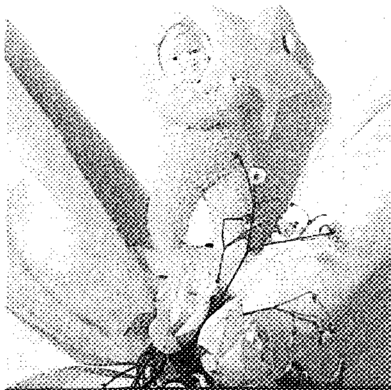
(Dollars in thousands, except per share amounts)	1997	*1996*	*1995*	*1994*
Net Sales	$219,496	$228,775	$252,047	$217,865
Income from Operations*	70,737	80,702	89,573	72,977
Net Income*	40,814	45,669	47,856	36,099
Net Income per Share*	1.95	2.10	2.20	1.67
Working Capital	$ 40,857	$ 67,997	$ 36,015	$ 13,362
Total Assets	259,695	285,733	259,085	239,680
Long-Term Debt	40,000	60,000	80,000	113,000
Stockholders' Equity	186,655	196,757	150,286	100,305

* *1997, 1996 and 1995 income from operations, net income and net income per share exclude recovery of import duties. 1997 net income and net income per share exclude the gain on sale of aircraft. 1995 net income and net income per share exclude the extraordinary charge due to debt refinancing.*



THE HISTORY OF

Snowbabies™

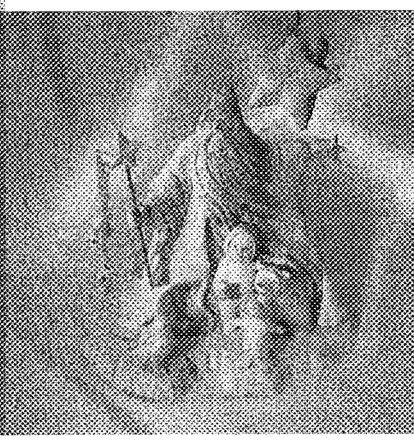


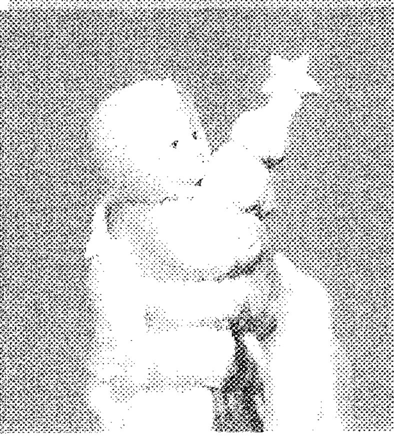
Snowbabies are unique Department 56 designs. Inspired by antique miniature German figurines, they delightfully portray the innocence of babies at play. Snowbabies live with their animal friends in Frosty Frolic Land – an imaginary world that exists on the surface of a sparkling snowflake.

Snowbabies not only tap into collectors' century-old interest in bisque figurines, they evoke the universal appeal of small children, playful animals and simple pleasures. Since their introduction in 1987, Snowbabies have become a leading line of porcelain bisque figurines, popular as gift items as well as desirable collectibles.

The broad variety of designs and moderate price points make Snowbabies attractive gifts. The titles of the figurines and the childhood themes fit many buyers' desire for a thoughtfully appropriate present that will strike a responsive chord with both the giver and the recipient.

The collectors' experience was enhanced in 1997 with the launch of the Snowbabies Friendship Club.™ The club offers exclusive-only-to-members several unique and special pieces as well as a regular newsletter.





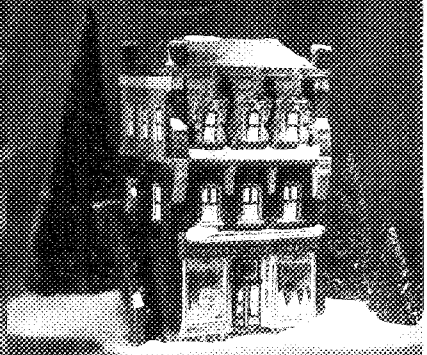
TWENTY YEARS OF...

The Original Snow Village®

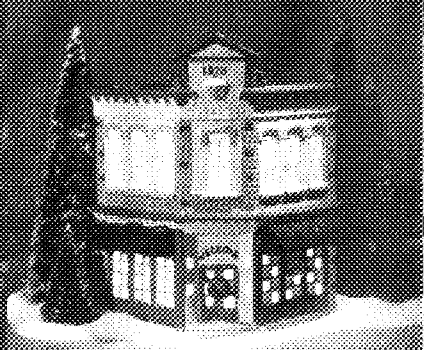
One Christmas evening, a group of friends set off to enjoy a dinner of celebration at a small country inn located in a quiet river town. As they rounded a bend in the road, they saw the small old-fashioned village, decorated for the holidays, lights glowing amid fresh fallen snow. All evening they talked of Christmas memories the vision of the little town brought back.

The idea to re-create a Christmas Village for everyone everywhere began that night. It became a reality in 1976 when Department 56 introduced a series of six hand-painted ceramic buildings. Since then, The Original Snow Village® collection has grown to include 215 lit houses, shops, churches, and a variety of other buildings and accessories. For over 20 years, The Original Snow Village has been an established tradition for families and collectors everywhere. An enduring concept and continuing innovation, as shown to the right, attracts new interest while extending the tradition.

1978



1983



1986

1990

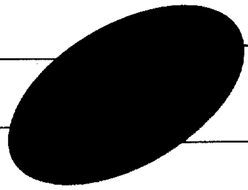
1997

PRODUCT

overview

Department 56 currently offers more than 3,000 products of which more than a third are new in 1998. Our annual product introductions and retirements create continuity and vitality among our core product lines, including lighted Village houses and accessories, Snowbabies and Snowbunnies.

1997 Sales Distribution



The Original Snow Village

INTRODUCED	1976
TOTAL LIGHTED PIECES	215
CURRENT LIGHTED PIECES	37
RETIRED LIGHTED PIECES	178

Village Accessories

CURRENT PIECES	172
RETIRED PIECES	210

Heritage Village Collection®

Dickens' Village Series,® New England Village,® Alpine Village Series,™ The Little Town of Bethlehem,™ Christmas in the City,® and North Pole.™

INTRODUCED	1984
TOTAL LIGHTED PIECES	270
CURRENT LIGHTED PIECES	90
RETIRED LIGHTED PIECES	180

Collectible Figurines

SNOWBABIES™

INTRODUCED	1987
TOTAL BISQUE PIECES	124
CURRENT BISQUE PIECES	65
RETIRED BISQUE PIECES	59

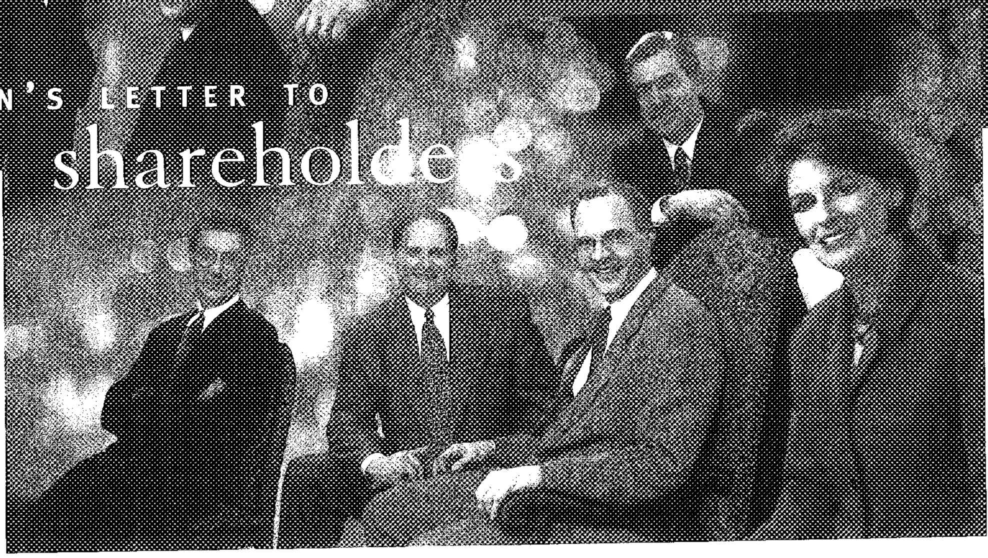
SNOWBUNNIES™

INTRODUCED	1994
TOTAL BISQUE PIECES	55
CURRENT BISQUE PIECES	26
RETIRED BISQUE PIECES	29

Christmas Trim and Everyday

lines include ongoing lines such as our Mercury Glass™ ornaments, Noel ornaments, and our Silver Collection. Once Upon a Starry Night™ and Life is Just a Bowl of Cherries™ lines are representative of the fresh and exciting new lines we introduce each year.

CHAIRWOMAN'S LETTER TO shareholders



TOP PHOTO–FROM LEFT: BRETT HEFFES, KEN SOBASKI, JOAN SERENA, YEH-HUANG LIN, DAVID WEISER, MARK KENNEDY, BRUCE WOLLAK
BOTTOM PHOTO–FROM LEFT: GREG SORENSEN, BOB ROSE, DAVID DEWEY, TIM SCHUGEL, SUSAN ENGEL

FEW COMPANIES CAN MATCH DEPARTMENT 56'S TRADITION OF GROWTH. Over the past two decades, revenue has grown in all but the last two years. A record with this consistency only results from careful cultivation of relationships with consumers over many years. The Original Snow Village® depicted on our cover, recently completed its twenty-year anniversary, while Snowbabies,™ depicted on the front foldout flap, just celebrated its tenth anniversary.

Our unique franchise remains exceptionally profitable and a tremendous generator of cash flow – even with the decreased revenue of the last two years. The hidden story of these years is management's commitment to strengthening, expanding and leveraging these assets.

Since I joined in 1994, we have strengthened Department 56 through several marketing and operational initiatives – including an ongoing study of retail inventories. Although basic to other industries, this type of study had never been done in the giftware business. The timing was fortuitous, as the study revealed an imbalance of inventory at retail.

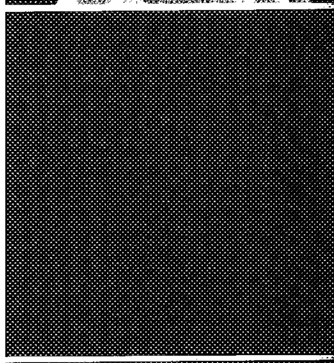
We promptly initiated a strategy to correct the situation. We purposely limited new product introductions, to the detriment of revenue, to allow consumers to absorb the extra supply. Clearly, our decisions would have been different if we were solely focused on short-term results. Our decision to accept lower revenue – combined with innovations to stimulate new consumer exposure and trial – helped balance inventory at retail. **WE PRESERVED THE COLLECTIBILITY AND STRENGTHENED THE LONG-TERM VALUE OF OUR UNIQUE FRANCHISES.**

Given the need to address retail inventory, we are very pleased by our 1997 results. Revenue was $219.5 million in 1997, compared to $228.8 million in the prior year. Net income, excluding the recovery of import duties and the gain on the sale of aircraft, was $40.8 million or $1.95 per share, compared to $45.7 million or $2.10 per share in the prior year, assuming dilution.

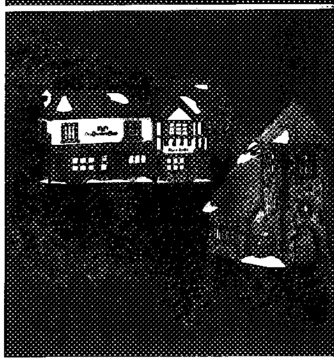
EARLY INDICATIONS SHOW VILLAGE ORDERS GROWING IN 1998. As of February 14, dealer orders for Villages were 8 percent ahead of the comparable period in 1997 – confirming the belief expressed last year that the order decline represented a pause in our wholesale growth. Dealer feedback indicates sales of our collectible products to consumers increased in 1997 – as they did in 1996. WE CONTINUE TO CAPTIVATE CONSUMERS THROUGH CREATIVITY AND INNOVATION.

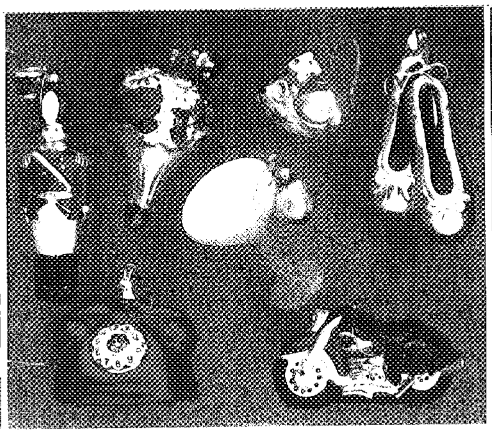
NEW INTERIOR DETAIL ENHANCES CONSUMER INVOLVEMENT with many of our 1998 Village introductions. The poinsettias and trees are visible through the windows of *Mrs. Claus' Greenhouse*. Looking through the doors, one can see the holiday revelers dancing inside our *Christmas Barn*. We've extended this new level of detail to our Historical Landmark Series™ by allowing consumers to see the stage inside *The Old Globe Theatre*. We continue to tap avid historical and cultural interest with this latest edition of the Historical Landmark Series.

The collectible and gift appeal of Snowbabies,™ our well-known porcelain bisque figurine line, was significantly strengthened through astute marketing. In this tenth anniversary year, we introduced the *Snowbabies Friendship Club*™ and supported retail marketing of this line with the first dedicated Snowbabies dealer event in the holiday season. These efforts led to INCREASED SNOWBABIES SALES IN 1997.



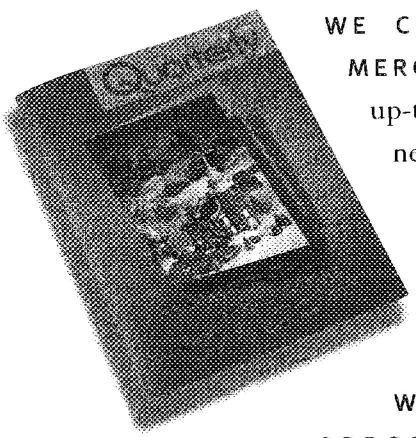
Overall, our GENERAL GIFTWARE CATEGORY PERFORMED EXCEPTIONALLY WELL IN 1997, driven by our ability to tap current consumer trends. Additionally, collectors and non-collectors enjoyed our new Classic Ornament Series. We extended the Village experience to the Christmas tree through ornaments based on proprietary Village designs, giving collectors a new way to enjoy classic pieces long since retired and REINFORCING OUR ROLE IN FAMILY AND HOLIDAY TRADITIONS.





WE CONTINUE TO REACH OUT TO NEW CONSUMERS through affiliation with popular American brands. The Harley-Davidson® Motorcycle Shop and related accessories were introduced in 1997 and became instant best-sellers. For the first time, a Village piece was offered through Harley-Davidson® dealerships as well as our traditional distribution. As non-traditional channels expose our products to new consumers, new collectors are created. Many traditional retailers recognized the opportunity and assisted their local Harley-Davidson® dealer with product display and cross-marketing opportunities.

WE ARE INTRODUCING McDONALD'S® TO OUR VILLAGES IN 1998. A new lit Village piece is reminiscent of the original "Golden Arches," evoking adult nostalgia for this American icon, while a Ronald McDonald character accessory provides strong identification for children. Also new for 1998 is the Hershey's™ Chocolate Shop lit piece and accessories. More than a handsome addition to the Village, the Hershey's™ Chocolate Shop makes a perfect stand-alone gift for the chocolate lover. **WE'RE EXCITED TO HAVE TWO MORE PREMIER BRANDS REFLECTED IN OUR 1998 PRODUCT INTRODUCTIONS.**



WE CONTINUE TO HELP OUR DEALERS STRENGTHEN THEIR MERCHANDISING EFFORTS. While our *Quarterly* keeps consumers up-to-date, effective merchandising is the focus of our *On-Time*™ dealer newsletter that shares best practices in display, marketing and selling our products. We are reaching out further in 1998 by making available display racks specially designed to highlight our Brite Lites™ accessory products and an exciting new ornament line. The goal is to help dealers generate add-on sales.

WE TOOK STEPS TO CAPTURE THE STRONG GROWTH OPPORTUNITY IN CANADA by agreeing to service our Canadian dealers with our full product line directly from our distribution centers in the fourth quarter of 1997. Canada decorates for the holidays in the same fashion as some of our strongest markets. By offering greater marketing support, credit terms and wholesale pricing comparable to that available in the United States, we hope to boost Canadian market penetration closer to the higher levels we see in the United States.

CREATIVITY IS WHAT MAKES GIFTWARE COMPANIES FINANCIALLY ATTRACTIVE, and we're deploying a unique, new investment strategy around this concept. Department 56 seeks to partner with creators of the most promising lines. Our objective is to build an investment portfolio that owns all or portions of the most creative collectible and giftware companies. One or more of these lines may ultimately capture the hearts and minds of consumers, developing into franchises as powerful as the ones that built Department 56. Our ultimate goal is to capture and share this added value with our partners.

We are creating a **RETAIL STORE CONCEPT** to showcase the breadth of our product line and bring the excitement of Department 56 merchandise to more consumers. This brand-building initiative will support, not supplant, our traditional dealers. As we expose our products to new consumers, the locations of dealers nearest them will be readily available.

"Tradition of Growth" conveys our vision of the future of Department 56 as much as it describes our past. **DEPARTMENT 56 CONTINUES TO BE MANAGED TO OPTIMIZE LONG-TERM VALUE—RATHER THAN SHORT-TERM RESULTS.** We've worked hard to communicate our management approach to investors, and we're gratified by a steadily rising stock price through most of 1997.

We salute our team of employees who work hard to bring innovation and excellence to all we do. Most of all, we appreciate the dealers and consumers that have made Villages and Snowbabies two of the most enduring franchises.

To the entire Department 56 family – employees, consumers, dealers, vendors and shareholders – we thank you for your ongoing enthusiasm and involvement in our business in 1997. Encouraged by the strong initial response to our 1998 product introductions, **WE LOOK FORWARD TO CONTINUING OUR TRADITION OF GROWTH.**

Susan E. Engel

Chairwoman and Chief Executive Officer

OFFICERS OF DEPARTMENT 56

David H. Weiser

THE BEST IN THE BUSINESS...

Department 56

- The 220 employees of Department 56, whose signatures form the background of this page, bring a new level of professionalism to this highly creative industry. They consistently demonstrate pride in their work and dedication to being the best in the business.

- Department 56 has consistently achieved profitability ratios among the best of all consumer product companies.

- Attractive margins are a function of Department 56's unique franchise and strong sourcing capabilities, which allows products with detail and quality at a price unmatched in our market.

- By outsourcing manufacturing, Department 56's growth does not require significant capital expenditures. Moreover, variable unit costs are held constant, giving management the flexibility to match product supply to market demand, while maintaining gross margins.

- By owning most concepts in the best-selling collectible products, Department 56's own creative efforts sustain product longevity and add value to the franchise.

- Department 56 generates strong and predictable free cash flow which it uses to enhance shareholder return, whether through reducing interest expense, repurchasing shares or investing in new business opportunities.

- Department 56 believes creativity makes giftware companies financially attractive, and seeks to partner with creators of the most promising lines. By leveraging its existing distribution and administrative capabilities, realizing opportunities for product synergy and providing the funds necessary for growth, Department 56 ultimately expects to capture and share the added value with partners.

- Department 56 has brought a new level of professional marketing and management to a highly creative industry. The management team is motivated and committed to enhance long-term shareholders' interest, and has consistently demonstrated this dedication in the past.

five-year summary

(In thousands, except per share amounts)	*Year ended Jan. 3, 1998* [1]	*Year ended Dec. 28, 1996* [1]	*Year ended Dec. 30, 1995* [1]	*Year ended Dec. 31, 1994* [1]	*Year ended Jan. 1, 1994* [1]
STATEMENTS OF INCOME					
Net sales	$219,496	$228,775	$252,047	$217,865	$184,359
Cost of sales	94,040	95,190	110,008	98,480	87,331
Gross profit	125,456	133,585	142,039	119,385	97,028
Operating expenses:					
Selling, general and administrative	50,142	48,306	47,889	41,831	34,670
Amortization of goodwill and trademarks	4,577	4,577	4,577	4,577	4,575
Recovery of import duties [2]	(370)	(453)	(2,872)	—	—
Total operating expenses	54,349	52,430	49,594	46,408	39,245
Income from operations	71,107	81,155	92,445	72,977	57,783
Other expense (income):					
Interest expense	4,362	6,063	9,582	12,629	16,143
Gain on sale of aircraft [3]	(2,882)	—	—	—	—
Other, net	(1,086)	(648)	(439)	(837)	(1,030)
Income before income taxes and extraordinary item	70,713	75,740	83,302	61,185	42,670
Provision for income taxes	27,932	29,796	33,737	25,086	17,673
Income before extraordinary item	42,781	45,944	49,565	36,099	24,997
Extraordinary charge due to refinancing of debt [4]	—	—	1,312	—	—
Net income	$ 42,781	$ 45,944	$ 48,253	$ 36,099	$ 24,997
Income before extraordinary item per common share assuming dilution [5]	$ 2.05	$ 2.11	$ 2.28	$ 1.67	$ 1.16
Net income per common share assuming dilution [5]	$ 2.05	$ 2.11	$ 2.22	$ 1.67	$ 1.16

	Jan. 3, 1998	*Dec. 28, 1996*	*Dec. 30, 1995*	*Dec. 31, 1994*	*Jan. 1, 1994*
BALANCE SHEET DATA					
Working capital	$ 40,857	$ 67,997	$ 36,015	$ 13,362	$ 26,392
Total assets	259,695	285,733	259,085	239,680	234,893
Long-term debt, including current maturities	40,000	60,000	80,000	113,000	148,000
Total stockholders' equity [6]	186,655	196,757	150,286	100,305	61,731

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

[2] See Note 8 to the Consolidated Financial Statements.

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

[4] See Note 4 to the Consolidated Financial Statements.

[5] See Note 11 to the Consolidated Financial Statements.

[6] The Company has not declared or paid dividends on its Common Stock. The Company does not anticipate paying dividends in the foreseeable future. As a holding company, the ability of the Company to pay cash dividends will depend upon the receipt of dividends or other payments from its subsidiaries. The revolving credit agreement of D 56, Inc. (the Company's principal operating subsidiary) permits it to declare and pay cash dividends (subject to certain limitations) to the Company which may then be declared and paid to holders of Common Stock.

MANAGEMENT'S

discussion and analysis

RESULTS OF OPERATIONS

COMPARISON OF RESULTS OF OPERATIONS 1997 TO 1996

Net Sales Net sales decreased $9.3 million, or 4%, from $228.8 million in 1996 to $219.5 million in 1997. This decrease was due principally to a decrease in volume. Sales of Village Series products decreased 9% from 1996 to 1997, while General Giftware product sales increased 7% during the same period. Village Series products continued to account for the most significant portion of the Company's sales, 64% in 1997 versus 67% in 1996.

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

Selling, General and Administrative Expenses Selling, general and administrative expenses increased $1.8 million, or 4%, between 1996 and 1997 principally due to a 20% increase in marketing expense and a 6% increase in administrative expense, offset by a 7% decrease in commission expense. Selling, general and administrative expenses as a percentage of sales increased from approximately 21% in 1996 to approximately 23% in 1997.

Recovery of Import Duties, Net The Company received net refunds of $.4 million and $.5 million in custom duties and related interest during 1997 and 1996, respectively. The duties pertained principally to certain merchandise imported into the United States from 1989 to 1994.

	1997		1996		1995	
(In millions, except per share amounts)	*Dollars*	*Percent of Net Sales*	*Dollars*	*Percent of Net Sales*	*Dollars*	*Percent of Net Sales*
Net sales	$219.5	100%	$228.8	100%	$252.0	100%
Gross profit	125.5	57	133.6	58	142.0	56
Selling, general and administrative expenses	50.1	23	48.3	21	47.9	19
Amortization of goodwill and trademarks	4.6	2	4.6	2	4.6	2
Recovery of import duties	(.4)	—	(.5)	—	(2.9)	(1)
Income from operations	71.1	32	81.2	35	92.4	37
Interest expense	4.4	2	6.1	3	9.6	4
Gain on sale of aircraft	(2.9)	(1)	—	—	—	—
Other, net	(1.1)	(1)	(.6)	—	(.4)	—
Income before income taxes and extraordinary item	70.7	32	75.7	33	83.3	33
Provision for income taxes	27.9	13	29.8	13	33.7	13
Income before extraordinary item	42.8	19	45.9	20	49.6	20
Extraordinary charge due to refinancing of debt	—	—	—	—	1.3	1
Net income	42.8	19	45.9	20	48.3	19
Income before extraordinary item per common share assuming dilution	2.05		2.11		2.28	
Net income per common share assuming dilution	2.05		2.11		2.22	
Operating cash flow [1]	81.7		88.1		99.1	

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

MANAGEMENT'S
discussion and analysis

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

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

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

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

COMPARISON OF RESULTS OF OPERATIONS 1996 TO 1995

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

Gross Profit Gross Profit decreased $8.5 million, or 6%, between 1995 and 1996. Gross profit as a percentage of sales increased from approximately 56.4% in 1995 to approximately 58.4% in 1996, principally due to increased manufacturing efficiencies and lower volume discounts as a percent of sales.

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

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

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

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

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

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 66% and 71% of its total annual customer orders for 1997 and 1996, respectively, during the first quarter of each of those years. Cancellations of total annual customer orders were approximately 8% and 6% in 1997 and 1996, respectively. The Company's backlog was $4.6 million and $7.2 million at January 3, 1998 and December 28, 1996, respectively.

The Company shipped and recorded as net sales approximately 90% and 92% of its annual customer orders in 1997 and 1996, respectively. Orders not shipped in a particular year, net of cancellations, returns, allowances and cash discounts, are carried into backlog for the following year and have historically been orders for Spring and Easter products.

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

	1997					1996				
(In millions, except per share amounts)	*1st Qtr.*	*2nd Qtr.*	*3rd Qtr.*	*4th Qtr.*	*Total*	*1st Qtr.*	*2nd Qtr.*	*3rd Qtr.*	*4th Qtr.*	*Total*
Customer orders entered[1]	$160.6	$43.8	$34.3	$6.2	$244.9	$177.5	$35.3	$28.3	$7.7	$248.8
Net sales	45.7	58.6	61.6	53.6	219.5	59.0	75.3	60.2	34.3	228.8
Gross profit	26.6	33.9	35.8	29.2	125.5	33.8	44.3	34.8	20.7	133.6
Selling, general and administrative expenses	11.1	11.4	12.1	15.5	50.1	11.5	13.0	11.7	12.1	48.3
Amortization of goodwill and trademarks	1.1	1.1	1.2	1.2	4.6	1.1	1.1	1.2	1.2	4.6
Recovery of import duties, net	(.4)	—	—	—	(.4)	(.2)	—	(.3)	—	(.5)
Income from operations	14.7	21.3	22.5	12.6	71.1	21.4	30.2	22.2	7.4	81.2
Net income	8.7	12.4	13.1	8.6	42.8	12.2	17.3	12.3	4.1	45.9
Net income per common share assuming dilution[2]	0.40	0.59	0.63	0.42	2.05	0.56	0.79	0.57	0.19	2.11

[1] *Customer orders entered are orders received and approved by the Company, subject to cancellation for various reasons including credit considerations, inventory shortages, and customer requests.*
[2] *See Footnote 11 to the Consolidated Financial Statements.*

MANAGEMENT'S discussion and analysis

LIQUIDITY AND CAPITAL RESOURCES

In February 1995, the Company entered into a new credit agreement providing a $100 million term loan and a revolving line of credit. In connection therewith, the Company recorded an extraordinary charge of $1,312,000, net of tax, to write off deferred financing costs during the first quarter of 1995. The Company used the proceeds of the term loan combined with $8 million of the revolving line of credit to refinance its subordinated debt.

The term loan is due and payable in installments of $20 million, payable in December of each year. At January 3, 1998, the term loan outstanding was $40 million.

The Company believes that its internally generated cash flow and seasonal borrowings under the revolving line of credit will be adequate to fund operations, capital expenditures, and required principal payments on its term loan for the next twelve months.

The revolving line of credit provides for borrowings of up to $90 million including letters of credit. The letters of credit are issued primarily in connection with inventory purchases. The credit agreement contains numerous financial and operating covenants, including restrictions on incurring indebtedness and liens, entering into any transaction to acquire or merge with any entity or making certain other fundamental changes, selling property, incurring capital expenditures and paying dividends. In addition, the Company and its principal operating subsidiary, D 56, Inc., are required to satisfy consolidated net worth, interest coverage ratio and current ratio tests, in each case at the end of each fiscal quarter. The available borrowings under the revolving line of credit were $85 million at January 3, 1998.

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

The Company's cash and cash equivalents balances peak in December, following the collection in November and December of accounts receivable with extended payment terms. Cash and cash equivalents balances decreased from $46.4 million at December 28, 1996 to $37.4 million at January 3, 1998 principally due to the repurchase of $55.2 million of stock and the repayment of $20.0 million of debt during 1997, offset by the increase in net cash provided by operating activities.

Accounts receivable decreased from $35.6 million at December 28, 1996 to $23.0 million at January 3, 1998, principally due to six days of additional cash collections in 1997 resulting from the timing of the Company's fiscal year end.

Capital expenditures were $7.8 million, $1.5 million and $1.6 million for 1997, 1996 and 1995, respectively. Included in 1997 capital expenditures is $4.9 million in connection with the Company's exercise of a purchase option under its aircraft lease agreement. See Note 6 to the consolidated financial statements. In addition, the Company is currently in the process of implementing a new information system. The new information system will significantly update the Company's current information system capabilities and is expected to eliminate the year 2000 issues for the Company's primary information systems. The Company plans to have the new information system substantially implemented by the first quarter of 1999. The new information system is expected to cost approximately $4 million.

Operating cash flow, defined as earnings before interest, income tax, depreciation and amortization expenses, decreased $6.4 million, or 7%, from $88.1 million in 1996 to $81.7 million in 1997. The decrease was principally due to the decrease in income from operations.

MANAGEMENT'S

discussion and analysis

The Company has a stock repurchase program. Under this program, the Company repurchased in the open market 2.2 million shares during 1997 at a weighted average price of $25 per share. The Company is authorized to repurchase an additional 0.8 million shares through the end of 1999. The timing, prices and amounts of shares repurchased will be determined at the discretion of the Company's management based on its view of prevailing economic and market conditions.

FOREIGN EXCHANGE

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

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

EFFECT OF INFLATION

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

RECENT DEVELOPMENTS

On February 23, 1998, the Company issued a press release stating in relevant part: "Dealer orders through February 14 [1998] were 8% higher than the comparable period in the prior year. Year-to-date Village orders were 8% higher than the comparable period in the prior year, while year-to-date orders for General Giftware were tracking 5% ahead." The press release also stated: "'We are pleased with [1997's revenue and earnings] given the need at the beginning of the year to further address retail inventories,' said Susan Engel, Chairwoman and CEO of Department 56. 'Data collected from a broad spectrum of dealers indicated a reduction in average retail inventory level in 1997, which was both significant and more substantial than in 1996.'"

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

Dealer orders are principally dependent on the amount, quality and market acceptance of the new product introductions and retailer demand. Dealer order patterns have historically varied in number, mix and timing, and there can be no assurance that the order trend experienced from January 4, 1998 through February 14, 1998 will continue. Moreover, the statements in the press release or throughout this annual report concerning retail inventory levels, consumer demand, and dealer expectations are based on statistical research conducted by or for the Company, and assume that such findings are correct and representative of market conditions as a whole.

Other factors, including product development efforts, completion of third party product manufacturing, dealer reorders and order cancellations, control of operating expenses, corporate cash flow application, and industry, general economic, regulatory and international trade conditions, can significantly impact the Company's sales and earnings. Actual results may vary materially from forward-looking statements and the assumptions on which they are based. The Company undertakes no obligation to update or publish in the future any forward-looking statements.

CONSOLIDATED
balance sheets

(In thousands, except per share amounts)	January 3, 1998	December 28, 1996
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 37,361	$ 46,405
Accounts receivable, net of allowances of $13,057 and $10,264, respectively	23,004	35,603
Inventories	18,070	20,526
Deferred taxes	6,303	5,048
Other current assets	3,008	1,721
Total current assets	87,746	109,303
Property and equipment, net	12,753	12,318
Goodwill, net of accumulated amortization of $21,683 and $17,554, respectively	143,491	147,620
Trademarks, net of accumulated amortization of $2,349 and $1,902, respectively	15,551	15,998
Other assets	154	494
	$259,695	$285,733
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Current portion of long-term debt	$ 20,000	$ 20,000
Accounts payable	9,973	7,618
Commissions payable	3,955	4,683
Other current liabilities	12,961	9,005
Total current liabilities	46,889	41,306
Deferred taxes	6,151	7,670
Long-term debt	20,000	40,000
Commitments and contingencies (Note 6)		
Stockholders' Equity:		
Preferred stock, $.01 par value; authorized 20,000 shares; no shares issued	—	—
Common stock, $.01 par value; authorized 100,000 shares; issued and outstanding 21,765 and 21,584 shares, respectively	218	216
Additional paid-in capital	44,645	42,315
Treasury stock, at cost; 2,199 and 0 shares, respectively	(55,215)	—
Retained earnings	197,007	154,226
Total stockholders' equity	186,655	196,757
	$259,695	$285,733

See notes to consolidated financial statements.

CONSOLIDATED

statements of income

(In thousands, except per share amounts)	Year ended January 3, 1998	Year ended December 28, 1996	Year ended December 30, 1995
Net sales	$219,496	$228,775	$252,047
Cost of sales	94,040	95,190	110,008
Gross profit	125,456	133,585	142,039
Operating expenses:			
Selling, general and administrative	50,142	48,306	47,889
Amortization of goodwill and trademarks	4,577	4,577	4,577
Recovery of import duties	(370)	(453)	(2,872)
Total operating expenses	54,349	52,430	49,594
Income from operations	71,107	81,155	92,445
Other expense (income):			
Interest expense	4,362	6,063	9,582
Gain on sale of aircraft	(2,882)	—	—
Other, net	(1,086)	(648)	(439)
Income before income taxes and extraordinary item	70,713	75,740	83,302
Provision for income taxes	27,932	29,796	33,737
Income before extraordinary item	42,781	45,944	49,565
Extraordinary charge due to refinancing of debt	—	—	1,312
Net income	$ 42,781	$ 45,944	$ 48,253
Income before extraordinary item per common share	$ 2.06	$ 2.13	$ 2.30
Income before extraordinary item per common share assuming dilution	$ 2.05	$ 2.11	$ 2.28
Net income per common share	$ 2.06	$ 2.13	$ 2.24
Net income per common share assuming dilution	$ 2.05	$ 2.11	$ 2.22

See notes to consolidated financial statements.

CONSOLIDATED

statements of cash flows

(In thousands)	Year ended January 3, 1998	Year ended December 28, 1996	Year ended December 30, 1995
Cash Flows from Operating Activities:			
Net income	$ 42,781	$ 45,944	$ 48,253
Adjustments to reconcile net income to net cash provided by operating activities:			
Extraordinary charge	—	—	1,312
Depreciation	2,031	1,721	1,609
Amortization of goodwill and trademarks	4,577	4,577	4,577
Provision for uncollectible accounts receivable	1,087	2,014	2,293
Gain on sale of aircraft	(2,882)	—	—
Compensation expense – common stock options	—	14	169
Deferred taxes	(2,774)	(37)	(1,528)
Changes in assets and liabilities:			
Accounts receivable	11,512	(3,349)	(12,605)
Inventories	2,456	8,533	(8,693)
Other assets	(1,337)	502	520
Accounts payable	2,355	1,019	1,442
Commissions payable	(728)	212	262
Other current liabilities	4,882	(1,379)	1,766
Net cash provided by operating activities	63,960	59,771	39,377
Cash Flows from Investing Activities:			
Purchases of property and equipment	(7,829)	(1,507)	(1,617)
Proceeds from sale of aircraft	8,567	—	—
Net cash provided by (used in) investing activities	738	(1,507)	(1,617)
Cash Flows from Financing Activities:			
Proceeds from the exercise of common stock options	1,473	336	865
Borrowings on revolving credit agreement	17,985	34,338	36,500
Principal payments on revolving credit agreement	(17,985)	(34,338)	(41,500)
Purchases of treasury stock	(55,215)	—	—
Proceeds from issuance of long-term debt	—	—	100,000
Principal payments on long-term debt	(20,000)	(20,000)	(128,000)
Net cash used in financing activities	(73,742)	(19,664)	(32,135)
Net increase (decrease) in cash and cash equivalents	(9,044)	38,600	5,625
Cash and cash equivalents at beginning of period	46,405	7,805	2,180
Cash and cash equivalents at end of period	$ 37,361	$ 46,405	$ 7,805

See notes to consolidated financial statements.

CONSOLIDATED

statements of stockholders' equity

(In thousands)	*Common Stock* Shares	*Common Stock* Amount	*Additional Paid-in Capital*	*Unearned Compensation on Common Stock Options*	*Treasury Stock*	*Retained Earnings*	*Total Stockholders' Equity*
Balance as of December 31, 1994	21,475	$215	$40,244	$(183)	$ —	$ 60,029	$100,305
Net income	—	—	—	—	—	48,253	48,253
Shares issued upon the exercise of common stock options	71	—	1,559	—	—	—	1,559
Common stock options vested	—	—	—	169	—	—	169
Balance as of December 30, 1995	21,546	215	41,803	(14)	—	108,282	150,286
Net income	—	—	—	—	—	45,944	45,944
Shares issued upon the exercise of common stock options	38	1	512	—	—	—	513
Common stock options vested	—	—	—	14	—	—	14
Balance as of December 28, 1996	21,584	216	42,315	—	—	154,226	196,757
Net income	—	—	—	—	—	42,781	42,781
Shares issued upon the exercise of common stock options	181	2	2,330	—	—	—	2,332
Shares repurchased	(2,199)	—	—	—	(55,215)	—	(55,215)
Balance as of January 3, 1998	19,566	$218	$44,645	$ —	$(55,215)	$197,007	$186,655

See notes to consolidated financial statements.

NOTES TO

consolidated financial statements

(In thousands, except share and per share amounts)

1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Principles of Consolidation The accompanying consolidated financial statements of the Company include the accounts of the Company and its subsidiaries. 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, 1995 and December 28, 1996 include 52 weeks and the year ended January 3, 1998 includes 53 weeks.

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

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

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

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

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

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

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

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

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

Foreign Exchange Contracts The Company imports certain product from Taiwan. To hedge its foreign exchange exposure, the Company may enter into foreign exchange contracts. The foreign exchange contracts reduce the Company's overall exposure to exchange rate movements, since the gains and losses on these contracts offset gains and losses on the transaction being hedged. 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 28, 1996 and January 3, 1998.

NOTES TO
consolidated financial statements

(In thousands, except share and per share amounts)

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

2 PROPERTY AND EQUIPMENT

Property and equipment is comprised of the following:

	Jan. 3, 1998	*Dec. 28, 1996*
Leasehold improvements	$ 1,253	$ 2,156
Furniture and fixtures	1,758	1,485
Computer equipment	4,646	2,540
Other equipment	4,804	4,756
Building	6,288	5,882
Land	906	906
	19,655	17,725
Less accumulated depreciation	6,902	5,407
Property and equipment, net	$12,753	$12,318

3 OTHER CURRENT LIABILITIES

Other current liabilities are comprised of the following:

	Jan. 3, 1998	*Dec. 28, 1996*
Accrued compensation and benefits	$ 3,377	$ 1,281
Income taxes payable	7,644	5,893
Deferred revenue	679	517
Accrued royalty fees	570	593
Other	691	721
	$12,961	$ 9,005

4 CREDIT AGREEMENT

Long-term debt is comprised of the following:

	Jan. 3, 1998	*Dec. 28, 1996*
Term loan	$40,000	$60,000
Less current portion	20,000	20,000
	$20,000	$40,000

The Company's credit agreement consists of a term loan and a revolving line of credit. The term loan is due and payable in annual installments of $20,000, payable in December of each year.

The revolving line of credit provides for borrowings of up to $90,000, which may be in the form of letters of credit, bankers acceptances, and revolving credit loans. The sum of the Company's revolving credit loans and bankers acceptances may not exceed an aggregate of $20,000 during any one 30 consecutive day period each calendar year. Borrowings under the credit agreement are subject to certain borrowing base limitations (as defined). The revolving line of credit provides for commitment fees of ¼% to ⅜% per annum on the daily average of the unused commitment. The available borrowings under the revolving line of credit were $85,341 at January 3, 1998.

The credit agreement allows the Company to choose between two interest rate options in connection with its term loan and revolving credit loans. The interest rate options are the Alternate Base Rate (as defined) or the Eurodollar

(In thousands, except share and per share amounts)

Rate (as defined) plus an applicable margin. The applicable margin ranges from ½% to 1¼% for Eurodollar loans. The credit agreement expires December 31, 1999.

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

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

The Company paid interest of $4,400, $6,129 and $10,086 during the years ended January 3, 1998, December 28, 1996 and December 30, 1995, respectively.

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

5 INCOME TAXES

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

	Year Ended Jan. 3, 1998	Year Ended Dec. 28, 1996	Year Ended Dec. 30, 1995
Current:			
Federal	$28,225	$27,376	$30,560
State	2,419	2,347	2,619
Foreign	62	110	272
Deferred	(2,774)	(37)	286
	$27,932	$29,796	$33,737

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

	Year Ended Jan. 3, 1998	Year Ended Dec. 28, 1996	Year Ended Dec. 30, 1995
Income taxes at federal statutory rate	$24,750	$26,509	$29,156
State income taxes, net of federal income tax	1,768	1,893	2,566
Amortization of goodwill	1,448	1,448	1,448
Other	(34)	(54)	567
Provision for income taxes	$27,932	$29,796	$33,737

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

	Jan. 3, 1998	Dec. 28, 1996
Deferred tax assets:		
Accounts receivable valuation allowances	$ 4,660	$ 3,516
Inventory valuation allowances	1,469	1,118
Compensation expense – common stock options	141	331
Accrued liabilities	264	354
Other	220	263
Total deferred tax assets	6,754	5,582
Deferred tax liabilities:		
Trademarks	(5,909)	(6,079)
Property and equipment	(440)	(1,986)
Other	(253)	(139)
Total deferred tax liabilities	(6,602)	(8,204)
	$ 152	$(2,622)

The $152 net deferred tax asset at January 3, 1998 is presented as a net deferred current asset of $6,303 and a net deferred noncurrent liability of $6,151. The $2,622 net deferred tax liability at December 28, 1996 is presented as a net deferred current asset of $5,048 and a net deferred noncurrent liability of $7,670.

The Company paid income taxes of $28,134, $28,943 and $31,855 during the years ended January 3, 1998, December 28, 1996 and December 30, 1995, respectively.

consolidated financial statements

(In thousands, except share and per share amounts)

6 COMMITMENTS AND CONTINGENCIES

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

The following is a schedule of future annual minimum lease payments for noncancelable operating leases as of January 3, 1998:

1998	$1,863
1999	1,325
2000	1,075
2001	518
2002	536
Thereafter	1,704
	$7,021

The Company's rental expense was $2,934, $3,238 and $2,875 for the years ended January 3, 1998, December 28, 1996 and December 30, 1995, respectively.

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.

Letters of Credit The Company had outstanding standby and commercial letters of credit amounting to $4,659 at January 3, 1998 relating primarily to purchase commitments issued to foreign suppliers and vendors.

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

7 RETIREMENT PLAN

The Company has a profit sharing plan covering substantially all employees. Contributions to this plan are at the discretion of the Board of Directors, subject to certain limitations. The Company's total profit sharing contributions were $1,136, $750 and $975 for the years ended January 3, 1998, December 28, 1996 and December 30, 1995, respectively.

8 RECOVERY OF IMPORT DUTIES

During the years ended January 3, 1998, December 28, 1996 and December 30, 1995 the Company received net refunds in custom duties and related interest of $370, $453, and $2,872 respectively. The refunds pertained principally to certain merchandise imported into the United States from 1989 to 1994.

9 RELATED-PARTY TRANSACTIONS

In the ordinary course of business, the Company sells product to a floral and nursery wholesaler and retailer, of which a director of the Company is an officer, director and stockholder. The Company had sales to this floral and nursery business during the years ended January 3, 1998, December 28, 1996 and December 30, 1995 of $1,323, $1,305 and $1,893, respectively.

During the years ended January 3, 1998, December 28, 1996 and December 30, 1995, the Company paid $1,343, $2,116 and $2,537 respectively, for aircraft management, transportation and other expenses to an affiliate of a director of the Company.

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

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

NOTES TO

consolidated financial statements

(In thousands, except share and per share amounts)

10 STOCKHOLDERS' EQUITY

Stock-Based Compensation Plans At January 3, 1998, the Company had four stock-based compensation plans. Under the 1992, 1993, 1995 and 1997 stock option plans, the Company may grant options to its directors, officers, employees, consultants and advisors of the Company for up to 292,500, 1,000,000, 600,000 and 1,500,000 shares of common stock, respectively. All employee options granted after the initial public offering have an exercise price equal to the market value of the common stock at the date of grant, generally have a term of 10 years, and generally are exercisable in equal installments on each of the first, second and third anniversaries of the date of the grant.

A summary of the status of the Company's four stock option plans as of January 3, 1998, December 28, 1996 and December 30, 1995, and changes during the years ended on those dates is presented below:

	1997		1996		1995	
Stock Options	*Shares*	*Weighted-Average Exercise Price*	*Shares*	*Weighted-Average Exercise Price*	*Shares*	*Weighted-Average Exercise Price*
Outstanding at beginning of year	1,291,908	$27.51	1,072,773	$31.73	702,755	$26.32
Granted	806,000	23.07	433,350	20.48	448,660	37.13
Exercised	(85,415)	13.53	(33,500)	9.36	(70,742)	12.23
Forfeited	(28,915)	31.93	(180,715)	39.09	(7,900)	31.26
Outstanding at end of year	1,983,578	26.25	1,291,908	27.51	1,072,773	31.73
Options exercisable at end of year	798,258	30.43	536,583	28.09	224,271	26.57
Weighted average fair value of options granted during the year	$10.96		$10.75		$16.07	

The Company applies Accounting Principle's Board Opinion No. 25 "Accounting for Stock Issued to Employees" and related interpretations in accounting for its plans. Accordingly, no compensation cost has been recognized for options granted since the initial public offering. Had compensation cost been determined based on the fair value of the 1995, 1996 and 1997 stock option grants consistent with the method of Statement of Financial Accounting Standards No. 123 "Accounting for Stock-Based Compensation" (SFAS 123), the Company's income before extraordinary item, net income, income before extraordinary item per common share assuming dilution and net income per common share assuming dilution would have been reduced to the pro forma amounts indicated to the right:

	1997	1996	1995
Income before Extraordinary Item			
As reported	$42,781	$45,944	$49,565
Pro forma	$40,245	$43,410	$48,885
Net Income			
As reported	$42,781	$45,944	$48,253
Pro forma	$40,245	$43,410	$47,573
Income before Extraordinary Item per Common Share Assuming Dilution			
As reported	$2.05	$2.11	$2.28
Pro forma	$1.93	$2.00	$2.25
Net Income per Common Share Assuming Dilution			
As reported	$2.05	$2.11	$2.22
Pro forma	$1.93	$2.00	$2.19

(In thousands, except share and per share amounts)

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 1997, 1996 and 1995, respectively: expected volatility of 38, 46 and 32 percent, risk-free interest rates of 6.2 percent, 5.8 percent and 6.0 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 plans at January 3, 1998:

Range of Exercise Prices	*Number Outstanding at Jan. 3, 1998*	*Weighted-Average Remaining Contractual Life*	*Weighted-Average Exercise Price*	*Number Exercisable at Jan. 3, 1998*	*Weighted-Average Exercise Price*
$ 3.33	52,013	4.1 years	$ 3.33	52,013	$ 3.33
18.00-21.47	1,052,971	8.8	20.87	171,009	19.73
21.48-37.75	878,594	7.8	34.04	575,236	36.06
	1,983,578			798,258	

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 1997, members of the Board of Directors exercised 95,000 options. At January 3, 1998, directors options to purchase 40,000 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 18½% 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 18½% 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, except in certain circumstance where there is a change in the majority of the Board of Directors. 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.

consolidated financial statements

(In thousands, except share and per share amounts)

11 INCOME PER COMMON SHARE

Effective December 15, 1997, the Company adopted Statement of Financial Accounting Standards No. 128, "Earnings per Share" (SFAS No. 128). Income per common share amounts presented for 1996 and 1995 have been restated for the adoption of SFAS No. 128. The following tables reconcile income before extraordinary item per common share and income before extraordinary item per common share assuming dilution:

	1997	1996	1995
Income before extraordinary item	$ 42,781	$ 45,944	$ 49,565
Weighted average number of shares outstanding	20,744,000	21,560,000	21,519,000
Income before extraordinary item per common share	$ 2.06	$ 2.13	$ 2.30

	1997	1996	1995
Income before extraordinary item	$ 42,781	$ 45,944	$ 49,565
Weighted average number of shares outstanding	20,744,000	21,560,000	21,519,000
Dilutive impact of options outstanding	152,000	199,000	228,000
Weighted average number of shares and and potential dilutive shares outstanding	20,896,000	21,759,000	21,747,000
Income before extraordinary item per common share assuming dilution	$ 2.05	$ 2.11	$ 2.28

Options to purchase 879,000 shares of common stock at exercise prices between $27 and $38 per share were outstanding at January 3, 1998 but were not included in the computation of income before extraordinary item per common share assuming dilution because the option exercise prices were greater than the average market price of the common stock.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL REPORTING

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

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

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

Susan E. Engel

Susan E. Engel
Chairwoman and Chief Executive Officer

INDEPENDENT AUDITORS' REPORT

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

We have audited the consolidated balance sheets of Department 56, Inc. and subsidiaries (the "Company") as of January 3, 1998 and December 28, 1996 and the related consolidated statements of income, cash flows and stockholders' equity for the years ended January 3, 1998, December 28, 1996 and December 30, 1995. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company at January 3, 1998 and December 28, 1996 and the results of its operations and its cash flows for the years ended January 3, 1998, December 28, 1996 and December 30, 1995 in conformity with generally accepted accounting principles.

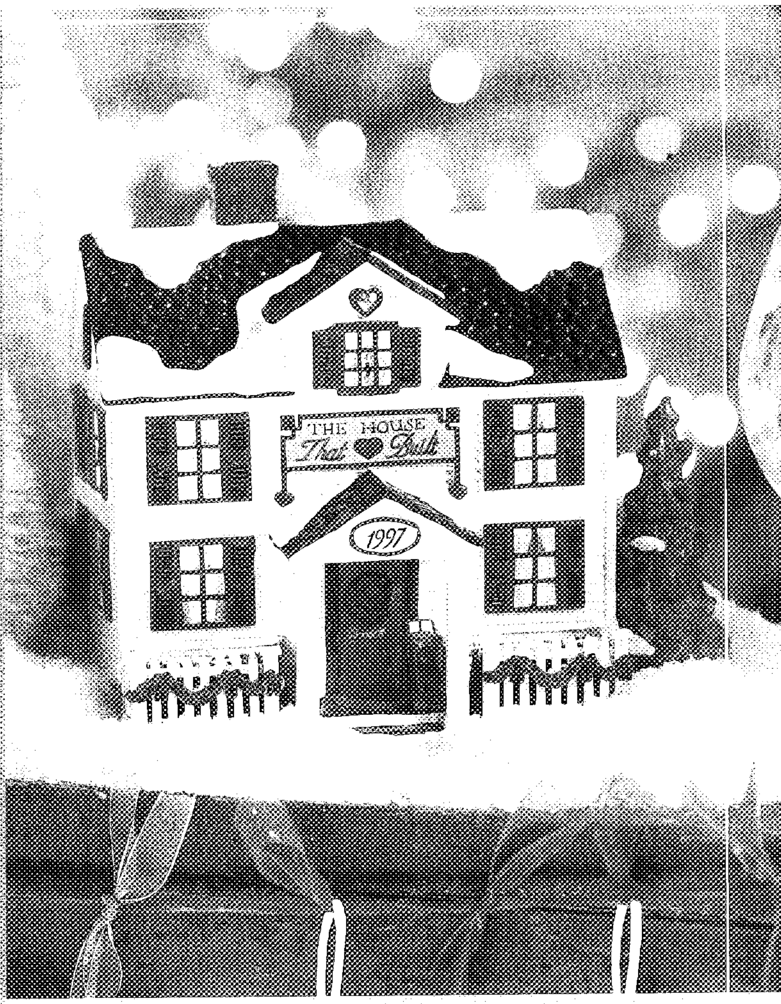
Deloitte & Touche LLP

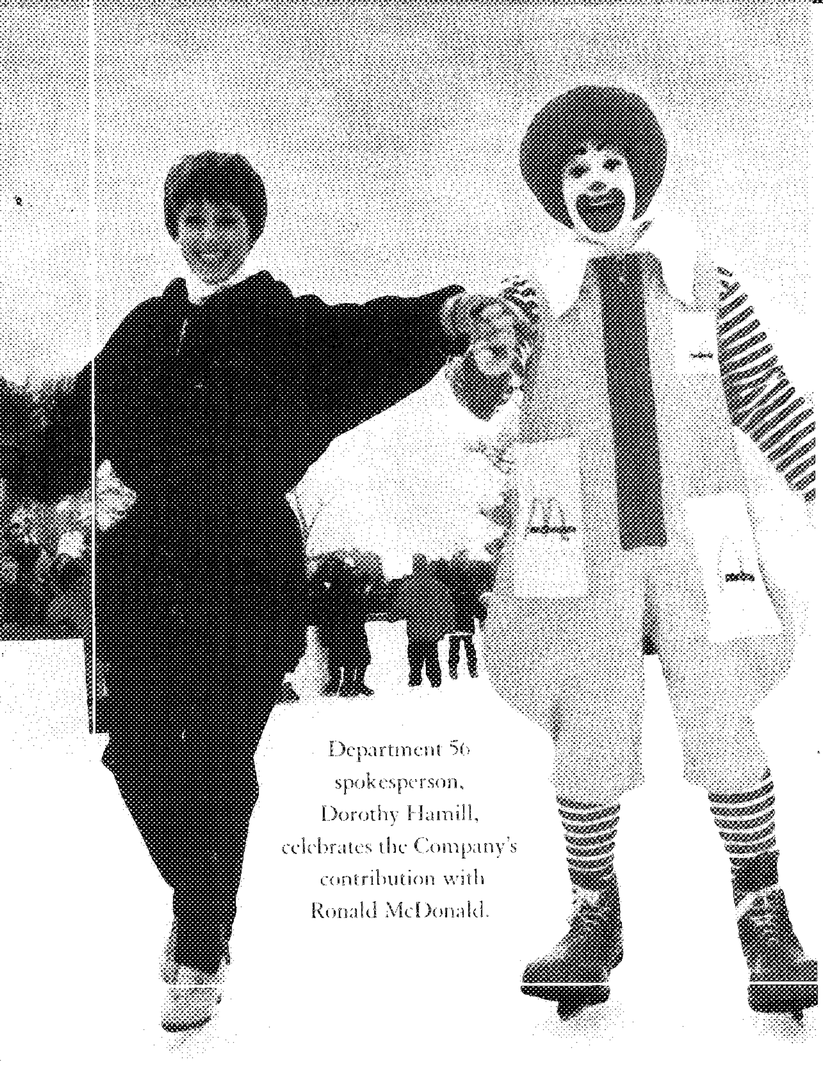
Minneapolis, Minnesota
February 12, 1998

DEPARTMENT 56

cares

THE DEPARTMENT 56 FAMILY CONTINUES ITS TRADITION OF CONTRIBUTING TO RONALD McDONALD HOUSE CHARITIES— the organization dedicated to serving families with children battling cancer and other serious illnesses. This family effort, including dealer's contributions, decorating services and in-store fund-raising events, as well as consumers' generous support, has made a difference at Ronald McDonald Houses throughout the United States and Canada since 1995. In 1997, the value of our contributions from our Homes For The Holidays™ event more than doubled to over $1 million.





Department 56 spokesperson, Dorothy Hamill, celebrates the Company's contribution with Ronald McDonald.

Department 56 created *The House That ♥ Built,*™ a special limited edition lit Village piece to be raffled or auctioned by participating dealers. Collectors responded with strong interest and premium-level bids at exciting in-store fund-raising events. Department 56 and participating dealers also donated a portion of each sale of *The House That ♥ Built*™ Christmas tree ornaments, and gave an ornament to each family with a child staying at the Houses during the holidays.

Department 56 continued its popular program of contributing lit Village pieces from the North Pole™ series to each Ronald McDonald House. Dealers played a vital role by arranging the displays – turning "Houses" into "Homes For The Holidays" – and helping families share the holiday spirit during stressful times. A stack of letters gives testimony to the positive impact these efforts had on families' lives.

corporate and stockholder information

BOARD OF DIRECTORS

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

Todd L. Bachman [2]
Chairman and
Chief Executive Officer
Bachman's Inc.

Maxine Clark
Founder and
Chief Executive Officer
Build-A-Bear Workshop

Sandra J. Horbach [1,3]
General Partner
Forstmann Little & Co.

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

Gary S. Matthews
President and
Chief Executive Officer
Guinness Import Company

Steven G. Rothmeier [2,3,4]
Chairman and
Chief Executive Officer
Great Northern Capital

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

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

OFFICERS

Susan E. Engel
Chairwoman and
Chief Executive Officer

David W. Dewey
Executive Vice President –
Overseas Operations

Brett D. Heffes
Vice President –
Corporate Development

Mark R. Kennedy
Senior Vice President
and Chief Financial Officer

Yeh-Huang Lin
Vice President –
D 56 Trading

Robert S. Rose
Vice President – Distribution
and Operations

Timothy J. Schugel
Vice President – Finance

Joan M. Serena
Vice President – Consumer
and Dealer Marketing

Kenneth J. Sobaski
Executive Vice President –
Sales and Marketing

Gregory G. Sorensen
Vice President – Management
Information Systems

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

Bruce R. Wollak
Vice President –
D 56 Sales

STOCKHOLDER INFORMATION

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

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

Independent Auditors
Deloitte & Touche LLP

Stock Listing
New York Stock Exchange
Symbol "DFS"

Annual Meeting
1:00 p.m.
May 14, 1998
Marriott Southwest Hotel
5801 Opus Parkway
Minnetonka, MN

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

1997	High	Low
First Quarter	\$24¾	\$16⅞
Second Quarter	\$23	\$17¼
Third Quarter	\$29 13/16	\$21
Fourth Quarter	\$31¾	\$27 7/16

1996	High	Low
First Quarter	\$41⅞	\$20
Second Quarter	\$26⅛	\$20
Third Quarter	\$25⅜	\$19½
Fourth Quarter	\$25¾	\$21⅛

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

As of February 19, 1998, there were 1,049 record holders of the Company's common stock.

CONSUMER INFORMATION

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