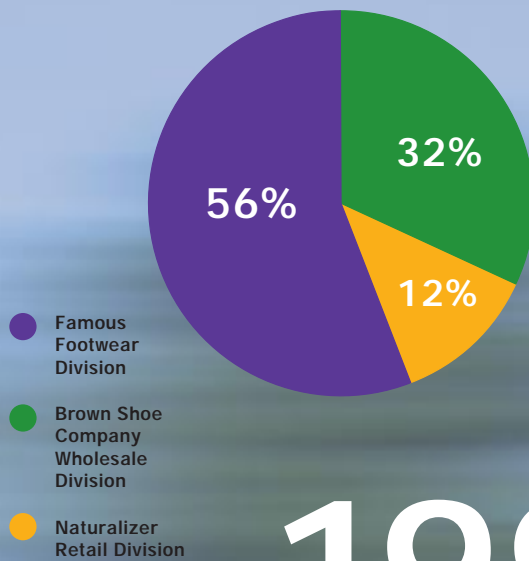


1 9 9 8 **Annual** Report

 Brown Group, Inc.



Brown Group, Inc.



1998 Financial Highlights

*For the Fiscal Years Ended January 30, 1999,
January 31, 1998 and February 1, 1997*

	1998	1997*	1996
<i>(Dollars in thousands, except per share data)</i>			
Operating Results			
Net sales	\$1,538,530	\$1,567,202	\$1,525,052
Net earnings (loss)	23,669	(20,896)	20,315
Per Share of Common Stock			
Diluted net earnings (loss)	1.32	(1.19)	1.15
Dividends paid	.40	.85	1.00
Shareholders' equity	11.95	11.04	13.19
Financial Position			
Total assets	655,232	694,988	722,375
Working capital	250,939	260,437	301,020
Shareholders' equity	217,174	199,190	237,037
Return on beginning shareholders' equity	11.9%	(8.8%)	8.8%
Current ratio	2.0:1	1.9:1	2.1:1

*In 1997, includes aftertax restructuring charges and operating losses of \$45.6 million related to the Company's Pagoda International marketing division, and a \$1.5 million aftertax loss on the sale of the Famous Fixtures division of Famous Footwear.

Going Places

Today's consumers are going places. And they need shoes that can get them there — shoes that reflect their sense of fashion and keep up with the demands of their active lifestyles.

Brown Group's businesses are positioned to offer today's footwear consumers what they need: comfortable, quality footwear... with relevant styling... in brand names they trust... in the places where they like to shop.

This positioning has served us well. With \$1.5 billion in annual sales, Brown Group ranks among the top ten shoe companies, retailing and wholesaling a wide variety of footwear for women, men and children. Last year was a good year for our company; with momentum in all our divisions, we are excited about the opportunities for further progress.

Brown Group is going places, too.

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active, time-stressed consumer. The consumer is telling us she likes the convenience of shopping in our stores, and she seeks our brand-name footwear because of the consistent value and quality it provides.

This is an exciting time for Brown Group — as we move into the 21st century, the opportunities for continued progress are significant. The leadership of B. A. “Dolph” Bridgewater, Jr., who retired as Chairman of Brown Group in January, helped the company maneuver through a time of great change in the footwear and retail industries. During the past 20 years of his stewardship, a framework for the company’s future growth and success was put in place. We intend to build on that foundation.

Plans for Continued Change

Our plans call for a continuation of change. The footwear industry is dynamic — chronic oversupply of product and far too much retail square footage continue to create pressure for industry consolidation, and continue to sift out the weak. Our strategy has been to transform Brown Group back to a company dedicated to operating and growing its footwear businesses. A significant proposal to

We are dedicated to forming one, integrated, increasingly efficient, brand-driven footwear operating company.

be considered by our shareholders at the Annual Meeting in May is the change of our company’s name to Brown Shoe Company, Inc. This new identity will reflect that we are a footwear company — rather than a holding company with diverse operations. We are dedicated to forming one, integrated, increasingly efficient, brand-driven footwear operating company, and having footwear industry leaders dedicated to delivering results that position Brown as a high-performing business. We know where we are — we know where we want to be — and we know what we have to do to get us there.

Revenue Growth a Priority; Leadership in Place

Over the years ahead, a principal element in Brown Group’s success will be top-line growth — we must deliver revenue growth in all of our businesses. To that end, we

In January 1999, the Board of Directors elected Brian C. Cook as an Executive Vice President of Brown Group. He also continues to serve as President of the company’s Famous Footwear division.

have assembled a leadership team committed to developing strategies to grow our business in the footwear industry. Gregory J. Van Gasse joined the team in September 1998 in the new position of President of the Brown Branded division. Other members of the team include Brian C. Cook, President of the Famous Footwear

division; Harry E. Rich, Executive Vice President and Chief Financial Officer; Gary M. Rich, President of the Pagoda division; and David H. Schwartz, President of the Brown Shoe Sourcing division. At our Naturalizer Retail division, Byron D. Norfleet joined the company as Senior Vice President and General Manager in July 1998.



Ronald A. Fromm was elected Chairman of the Board, President and Chief Executive Officer of Brown Group, Inc. in January 1999. His previous positions at Brown Group included President — Brown Shoe Company, and Executive Vice President and Chief Financial Officer — Famous Footwear.

Dear **Shareholder**

We are pleased to report that **1998** was a year of continued progress for Brown Group, providing a solid platform for building our future.

In last year's Annual Report, we said that our plans for 1998 called for continuing progress in our core businesses and a major improvement in net earnings. This report will describe a year in which we delivered on that promise. Our 1998 results were achieved during a difficult year for the shoe industry, when many of our competitors struggled with a downturn in athletic shoe demand and a highly promotional retail marketplace.

In 1998, Brown Group earned \$23.7 million, or \$1.32 per share, on sales of \$1.5 billion — an encouraging return to solid profitability. These results include a \$7.5 million loss associated with the planned withdrawal from our international licensed business. In 1998, our core operations earned \$31.2 million, or \$1.74 per share. This performance reaffirms the earning capability of Brown Group and sets the stage for further improvements.

These results are particularly encouraging to me, as the new Chairman of Brown Group. I would like to thank all of the talented associates whose dedication, commitment and teamwork were an essential element of the success achieved in 1998. There are three major trends affecting the footwear industry today: the increasing time pressure of work and family leave consumers with less opportunities to shop; the American lifestyle continues to favor more casual attire; and the preference for athletic footwear continues to decline. Our businesses address the needs of today's

active, time-stressed consumer. The consumer is telling us she likes the convenience of shopping in our stores, and she seeks our brand-name footwear because of the consistent value and quality it provides.

This is an exciting time for Brown Group — as we move into the 21st century, the opportunities for continued progress are significant. The leadership of B. A. “Dolph” Bridgewater, Jr., who retired as Chairman of Brown Group in January, helped the company maneuver through a time of great change in the footwear and retail industries. During the past 20 years of his stewardship, a framework for the company’s future growth and success was put in place. We intend to build on that foundation.

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**A Year of Record Retail Performance —
Famous Footwear's Operating Earnings Increase 25 Percent**

Our 1998 results were led by the excellent performance of the Famous Footwear division. Sales and earnings for Famous Footwear reached record levels in 1998. Retail sales of \$861 million during the year were 4 percent higher than last year. Operating earnings rose 25 percent to \$47.2 million. This gain reflects continued improvements in execution, including higher margins, very good expense management and successful merchandising and marketing strategies to overcome the decline in demand for athletic footwear. These results are very encouraging, reestablishing Famous Footwear as a high-performance retailer, with Return on Invested Capital exceeding 10 percent in 1998 — a goal that the entire Famous Footwear team set out to accomplish at the beginning of the year.

At the company's Naturalizer Retail operations in the U.S. and Canada, a sales gain of 3 percent to \$187.2 million for the year also reflects the encouraging momentum of our Naturalizer brand. Operating earnings were \$.8 million versus \$2.3 million last year. This reflects record results for the Canadian retail operations, offset by losses in the U.S. operations due to higher store operating costs.

**Earnings Gains for Combined Wholesale Operations —
Naturalizer Sales Increase 9 Percent**

The company's wholesale operations — the Brown Branded, Pagoda, and Canadian Wholesale divisions — also achieved improved results during 1998. Operating earnings

increased 5 percent to \$33.5 million on a 2 percent sales gain to \$455.9 million. These results were led by continued strengthening of the Naturalizer brand, including a 9

With the dramatic improvement in our operating results last year, Brown Group generated positive cash flow of \$49.2 million, and our balance sheet was materially strengthened.

percent sales increase, as it continues to achieve increasing consumer acceptance and new retail distribution. Performance also was strong for the Pagoda Children's division and the Dr. Scholl's brand.

Balance Sheet Strengthened; Business Withdrawal Completed

With the dramatic improvement in our operating results last year, Brown Group generated positive cash flow of \$49.2 million, and our balance sheet was materially strengthened. Our net debt to capital ratio was reduced to 41 percent from 50 percent at the end of fiscal year 1997. Inventories were tightly controlled in all operations during the year, ending the period well below plan and below last year.

We are very pleased to report that the withdrawal from the Pagoda International marketing division has been substantially completed. Virtually all the inventory has

been sold, all licenses either terminated or assigned to other parties, and only minimal office operations retained.

Looking Ahead: Continued Improvements; Building Value

With the solid performance of our operating divisions in 1998 and the final phase-out of our Pagoda International division, we plan to record significant improvement in operating earnings for fiscal year 1999. We are now in a strong position to capture market share in the consolidating shoe industry. Our plans call for us to grow both our retail operations and our wholesale businesses. Building

The strong positioning of Brown Group's businesses with today's consumer, our strengthened balance sheet, and proven leadership in all of our operations, provide good prospects for continued improvements.

on the momentum at Famous Footwear, a more aggressive rate of store openings is planned for 1999. We also expect that the progress of our Naturalizer brand will continue at both wholesale and retail in 1999. We have programs in place to build on the success of our Life Stride brand and to roll-out our repositioned NaturalSport brand. We also see exciting potential in our Pagoda operations, capitalizing on the opportunities of our Star Wars, Barbie and Dr. Scholl's licensed products.

The strong positioning of Brown Group's businesses with today's consumer, our strengthened balance sheet, and proven leadership in all of our operations, provide good prospects for continued improvements. As a shareholder of Brown Group, you can be assured that we are intensely focused on building the value of this company. We know that it will take consistent growth in sales and earnings of our businesses to increase the value of your investment in Brown Group. We are committed to achieving that goal.



Ronald A. Fromm
Chairman of the Board, President
and Chief Executive Officer

April 23, 1999

Director Retirements : At the Annual Meeting of Shareholders in May, retired Brown Group Chairman B. A. "Dolph" Bridgewater also will retire from the Brown Group Board of Directors. Other Directors planning to retire from the Board at the Annual Meeting include William E. Maritz, John D. Macomber and General Edward C. Meyer. The wise counsel of each of these Directors has been instrumental in shaping the company's current and future success.

Famous Footwear

Better than the Rest

Famous Footwear is relentlessly pursuing its mission to be America's number one choice for fashionable, branded family shoes. This high-performance retailer had a record year in 1998, measured in both sales and operating earnings. In a crowded retail marketplace, Famous Footwear continues to offer consumers a shopping experience that's "better than the rest."

The One-Stop-Shop for the Family's Shoes

In 1998, Famous Footwear made great strides in building its product selection and service capabilities to satisfy every footwear need of its target consumer: a busy woman who does all of the family shoe shopping. When she enters a Famous Footwear store, *she wants to buy shoes*. She neither has the time nor the desire to make several trips to several stores. Famous Footwear renewed its commitment to this consumer in 1998 — setting a goal that every time she enters a store, she leaves with all of the shoes she set out to purchase.

Famous Footwear has expanded its brand mix as well as the sizes and widths of its product selection — making it more likely than ever that the Famous Footwear shopper finds a shoe that fits her lifestyle and budget. Specifically, the company has extended its offering of high-profile brands that appeal to the consumer's desire for fashion and comfort. These brand extensions position the chain to take advantage of the consumer's movement away from athletic shoes. While demand for athletic footwear has dropped in recent years, especially among men, the company still expects its target woman consumer to satisfy her family's athletic shoe needs at Famous Footwear stores.



Famous Footwear has 827 stores in 48 states and Guam. These stores average more than 5,500 square feet in size, with average annual store sales of more than \$1 million.

Beating the Competition with Value and Service

Key to the company's successful brand extensions is its growing reputation for providing value to the consumer — not just low prices. This emphasis on value has been a critical factor in building relationships with the company's major suppliers. Having big-name brands draws consumers into the stores; but only great service ensures they leave with the shoes they want. Famous Footwear brought service to the forefront in 1998 by re-emphasizing it as a priority to all store associates — and training them to help the customer find what she wants and feel good about her shopping experience.

In addition to training, a key strategy for Famous Footwear is attracting and retaining quality people who are dedicated to providing good customer service. The chain also has an ongoing program of

closing lower-volume stores that cannot offer a large selection of merchandise

Famous Footwear is America's #1 choice for fashionable branded family shoes, providing a shopping experience that always makes the customer feel good.

and the staffing needed to provide superior service. This focus on larger-volume stores is being driven by more than the service component, however; it also reflects marketplace dynamics that increasingly reward larger stores with a competitive advantage over their smaller counterparts.

In 1999, Famous Footwear associates will be equipped to provide even greater customer service: the chain is replacing all store information systems with a state-of-the-art retail operating system. The company expects to complete the roll-out of the new system to all Famous Footwear stores by July 1999. New efficiencies expected from the system include faster credit-card approval and improved information. All stores will be connected on-line with the chain's headquarters in Madison, Wisconsin, which will enable real-time communication between each store and the company's main database. The new technology will result in significant savings on systems and communications, and Famous Footwear shoppers will see the benefits of the new system in faster service and better information.

Becoming More Efficient — and Prepared to Grow

Famous Footwear finished fiscal year 1998 with 827 stores in 48 states and Guam. These stores average more than 5,500 square feet in size, with average annual store sales of more than \$1 million. The company has significant penetration in regional malls, power strip centers and outlet centers — the places people shop for shoes. A realignment of its field management structure in 1997 put more managers in the field to operate the business directly, so now the company's scope of supervision covers virtually the entire country.

The company's two distribution centers continued to deliver increased operational efficiencies in 1998, enabling the chain to get the right product to the right store at the right time. These new logistical efficiencies provide improved service and more flexibility in opening stores farther away from the centers by reducing cycle times for replenishing store inventories. Together, the company's wide supervision and distribution capabilities, position Famous Footwear to increase the rate of store openings in 1999 versus recent years, without significantly increasing field management or marketing.

The company revamped its marketing in 1998: streamlining its media buying to more effectively target its primary consumers, and reinforcing its “value” message by incorporating more brand and fashion presentation in its advertising. The company’s Celebrity Club customer loyalty program continues to be a success with more than three million members who are rewarded for frequent purchases and included in targeted promotional mailings and special offers. These valued customers buy more pairs of shoes annually and spend more per sales transaction than other customers. The company plans to expand the program to all its stores by the end of 1999. Celebrity Club is a microcosm of the Famous Footwear philosophy: delivering the customer the best value — and service — on quality, branded footwear.

Naturalizer Retail

The Spirit of Naturalizer



There are 331 company-operated Naturalizer stores in the U.S. and 131 in Canada.

The company’s Naturalizer Retail division offers a large selection of casual and dress footwear that appeals to the active woman’s lifestyle. Naturalizer specialty stores are destination-shopping points for loyal Naturalizer consumers, who want the highest level of service, selection and sizes. There currently are 331 company-operated U.S. Naturalizer stores and 131 in Canada. In addition, the Naturalizer brand is sold in 78 independently operated Naturalizer stores in the United States and 41 in other countries, building the brand’s worldwide recognition.

Despite a year characterized by intense competition and lackluster performance for the shoe industry overall, the Naturalizer Retail division improved store-for-store performance, an indication of the continuing strength of the Naturalizer brand. The challenge going forward is to transform Naturalizer from simply being a leading women’s shoe brand to becoming an essential element for the lifestyle of the brand’s target consumer.

The Naturalizer Retail division has several programs underway to improve the performance of the stores, including revamping the design to ensure that the shopping environment is sophisticated, inviting and easy-to-shop. The company continues to merchandise its stores for a better balance of casual and dress styles to appeal to the lifestyle needs of the brand’s target consumer. New marketing programs are being tested to provide improved communications with the target consumer. A more aggressive real estate repositioning program is aimed at closing poorly performing stores and opening more stores in better locations. Updated point-of-sale registers and a new merchandising reporting system were rolled out in 1998, and are providing improved information on inventories and consumer preferences.

Brown Shoe Company

Reaching the Consumer

The goal of Brown Shoe Company's wholesale operations is to put comfortable, fashionable, quality footwear on as many consumers as possible. And the company's strategy for reaching consumers is really quite simple: being everywhere they shop with shoes that fit their lifestyles and their tastes in fashion. Successful execution of this consumer-reach strategy requires a powerful lineup of branded products and strong relationships with retail partners.

Building Brands That Fit Consumer Lifestyles

The power of the company's branded products fuels growth in both its

wholesale and retail operations. Brands are more important than ever in reaching today's time-

deprived consumers, who make quick and easy shopping decisions by choosing brand name products they can count on for quality and value. In 1998, the company continued building brands that mean comfort, functionality, relevant styling and affordable pricing to a growing number of consumers.

Consumer research shows that Naturalizer (left) and Life Stride are ranked among the top women's shoe brands today.



A focus on brands is deliberately built into the structure of Brown Shoe Company through its three wholesale divisions. The *Brown Branded division* speaks directly to the needs of today's fashion-oriented woman, with high-quality footwear in relevant styles sold at department and specialty stores. The company's Naturalizer brand has earned a reputation for style and comfort among women who shop at department and specialty stores. New distribution and a rejuvenated product line pushed Naturalizer to significant growth in 1998.

The Naturalsport brand continues to create a name for itself among younger women with active lifestyles, a consumer segment that represents increased opportunities for the brand going forward. Life Stride and its brand extension, LS Studio, continue to dominate the "entry level" shoe category in department and specialty stores, capitalizing on the growing

Brands are more important than ever in reaching today's time-deprived consumers, who make quick and easy shopping decisions by choosing brand name products they can count on for quality and value.

popularity of casual styles among its target consumers. The Night Life brand is the company's line of women's shoes for special occasions. Using the Millennium as the ultimate

special occasion, the brand is gaining increased recognition and new distribution. Together, the Naturalizer, Naturalsport, Life Stride and Night Life brands cover the full spectrum of affordability and lifestyle fashion for today's consumer.

The *Pagoda division* of Brown Shoe Company makes quality footwear affordable to the growing numbers of consumers who do the family shoe shopping at mass-merchandisers and mid-tier retailers — increasingly important retail channels for the footwear industry. In 1998, the company entered into two new licensing agreements to market footwear featuring characters from the 1999 movies *Star Wars: Episode I* and Disney's *Tarzan*.

The Pagoda division is building the presence of its licensed and branded products in all channels of distribution. Children's footwear sales to mass-merchandisers, mid-tier retailers and department stores were significantly increased in 1998, led by Buster Brown, Barbie and lighted footwear. Buster Brown continues to be one of the most recognized brand names in children's shoes. Sales of Barbie footwear increased 119 percent in 1998, which marked Barbie's 40th anniversary and the 12th year of Pagoda's footwear licensing relationship with this powerful brand. Pagoda's long-standing presence in adult brands is anchored by well-known brand names such as Dr. Scholl's, Connie, Russell Athletic, Penn and Unionbay.



Sales of the Dr. Scholl's brand (left) increased 5 percent in 1998. The company also markets children's footwear under powerful licensed brand names.

At the heart of the company's brand-driven organization is its *Brown Shoe Sourcing division*, which ranks among the largest and most versatile footwear suppliers today. This worldwide sourcing network contracts with footwear manufacturers in China, Brazil,



Buster Brown is a trusted name in children's shoes.

The **power** of Brown Shoe Company's branded products **fuels growth** in both its **wholesale** and **retail** businesses.

Indonesia, Italy, Mexico and Taiwan to produce shoes that meet the company's design, quality, delivery and price standards. The company has an ongoing program to ensure that these factories meet its strict standards for working conditions and quality. In 1998, the company sourced approximately 60 million pairs of shoes through its seven international sourcing offices. In this way, Brown Shoe Sourcing provides a flexible, cost-efficient means for supporting the diverse lifestyles of today's footwear consumers with virtually every category of shoe — from athletic to dress — at virtually every level of affordability — from popular priced to better brands.



The Naturalsport brand has been repositioned for a younger, casual lifestyle.

Partnering to Open the Gateway to the Consumer

Retail partners are the gatekeepers to an enormous consumer market for footwear — and critical to expanding the company's consumer reach. In 1998, Brown Shoe Company strengthened its relationships with specialty stores, department stores and mass-merchandisers. The success of the company's bellwether Naturalizer brand helped open an additional 220-plus department store doors for Brown Shoe Company. Naturalizer sales to department store retailers increased 24 percent in 1998, and sales rose 11 percent at multi-line independent specialty stores. The company's mass-merchandise and mid-tier customers include powerful retailers, such as Wal-Mart, Kmart, Payless ShoeSource and of course, Famous Footwear. Brown Group's Canadian Wholesale division, located in Perth, Ontario, maintains strong retail partnerships as well, closing the year with extensive brand representation in department stores, better-grade independent accounts and specialty stores throughout Canada.

Brown Shoe Company is uniquely positioned to serve its retail partners with sophisticated merchandising and logistic support systems, a flexible worldwide sourcing network, proven product development teams, and strong marketing and merchandising programs to reach its consumers. With a portfolio of leading brands supported by a diversified sourcing network, and a strong customer base across all retail channels, Brown Shoe Company is in a strong position to seize its opportunities and to build on the momentum established in fiscal year 1998.

Stores and Brands

at a Glance

Footwear Retail Stores

	Number of Stores				
	1998	1997	1996*	1995	1994
Famous Footwear: Family footwear stores which feature "brand names for less;" located in strip centers, outlet and regional malls in the U.S.	827	815	794	814	722
Naturalizer: Stores selling the Naturalizer and Naturalisport brands of women's footwear; located in major malls, shopping centers and outlet malls in the U.S. and Canada.	462	464	462	424	432

* Reflects the transfer of 40 Naturalizer outlet stores from the Famous Footwear division to the Naturalizer Retail division.

Footwear Brands

WOMEN'S

Air Step
 Connie
 Connie Too
 Dr. Scholl's ¹
 Fanfares
 Naturalizer
 Naturalisport
 Life Stride
 Larry Stuart Collection
 le coq sportif
 LS Studio by Life Stride
 Maserati
 Mickey Unlimited ²
 Night Life
 Original Dr. Scholl's ¹
 Penn ³
 Russell Athletic ⁴
 Unionbay ⁵

CHILDREN'S

Barbie ⁶
 Buster Brown
 Disney Babies ²
 Flash Tech
 Hello Kitty ⁷
 The Land Before Time ⁹
 Live Wires
 le coq sportif
 The Lion King ²
 Mickey & Co. ²
 Mickey for Kids ²
 Mulan ²
 Simba's Pride ²
 Sound Efx
 Star Wars ⁸
 Tarzan ²
 Wildcats

MEN'S

Big Country
 Cedar Trail
 Dr. Scholl's ¹
 Jean Pier Clemente
 le coq sportif
 Nature Sole
 Penn ³
 Regal
 Russell Athletic ⁴

As denoted, these brands are under license from:

- ¹ Schering-Plough HealthCare Products, Inc.
- ² The Walt Disney Company
- ³ Penn Racquet Sports, a division of GenCorp, Inc.
- ⁴ Russell Corporation
- ⁵ Seattle Pacific Industries, Inc.
- ⁶ Mattel, Inc.
- ⁷ Sanrio, Inc.
- ⁸ Lucasfilm Ltd.
- ⁹ Universal Studios

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Management's Discussion and Analysis of Operations and Financial Condition

Results of Operations

1998 Compared to 1997

Brown Group, Inc.'s fiscal 1998 results reflect continuing progress during a difficult and highly promotional year in the footwear marketplace.

Brown Group, Inc.'s net sales of \$1.539 billion in fiscal 1998 were \$28 million lower than the \$1.567 billion in fiscal 1997. Net sales were impacted by the withdrawal from the Pagoda International marketing division and the sale of Famous Footwear's fixtures manufacturing business at the end of fiscal 1997. Adjusting for these items, net sales increased 3%, led primarily by Famous Footwear. Net earnings of \$23.7 million in fiscal 1998 compares to a net loss of \$20.9 million in fiscal 1997. The net loss in fiscal 1997 includes \$45.6 million of Pagoda International restructuring charges and operating losses compared to a loss of \$7.5 million incurred in fiscal 1998. Excluding the Pagoda International results and the aftertax loss of \$1.5 million incurred on the sale of the Famous Fixtures business in fiscal 1997, net earnings of the Company's core businesses were \$31.2 million in fiscal 1998 compared to \$26.2 million in fiscal 1997.

In fiscal 1998, Famous Footwear achieved record sales and operating earnings. Net sales increased 1% in fiscal 1998 to \$861.3 million and 4% adjusting for the sale of the Famous Fixtures business. Same-store sales increased .4% and 12 net new stores were added in fiscal 1998. Sales per square foot increased 3.2% in fiscal 1998 reflecting improved store productivity from the new stores opened versus those stores closed in the past year. At the end of fiscal 1998, 827 stores were in operation compared to 815 stores in fiscal 1997. During the year, 60 stores were opened and 48 stores were closed, with plans for fiscal 1999 including the net addition of 30 to 40 stores. Excluding the effect of the sale of the fixtures business, operating earnings for fiscal 1998 increased 25% to \$47.2 million as a result of higher gross margins, good expense management and successful merchandising strategies to overcome a decline in athletic footwear sales.

The Company's wholesale operations—the Brown Branded, Pagoda and Canadian Wholesale divisions—had a net sales increase of 2% during fiscal 1998 to \$455.9 million. Sales of the Naturalizer brand increased 9% in 1998 reflecting the good consumer acceptance and new retail distribution of the brand. Operating earnings of \$33.5 million increased 5% in fiscal 1998 resulting from improved margins and well-controlled operating expenses.

In the Company's Naturalizer Retail operations, which includes stores in both the United States and Canada, net sales of \$187.2 million increased 3% in fiscal 1998. Same-store sales in fiscal 1998 increased 2.6% and 1.2% in the United States and Canada, respectively. At the end of fiscal 1998, 462 total stores were in operation including 331 stores in the United States and 131 stores in Canada. Domestically, the Company had a net decrease of 10 stores in fiscal 1998 while Canada had a net increase of 8 Naturalizer stores. Even though the Canadian operations performed at record levels, total Naturalizer Retail operations had operating earnings of \$.8 million in fiscal 1998 compared to \$2.3 million in fiscal 1997. Operations in the United States stores were adversely impacted by higher store operating costs.

Consolidated gross profit as a percent of sales of 39.9% in 1998 was higher than the 37.9% in 1997 which excludes the impact of the Pagoda International restructuring charge of \$14.7 million. The improvement in gross profit rate reflects increases at Famous Footwear and the wholesale operations.

Selling and administrative expenses as a percent of sales of 35.9% in 1998 was higher than the 35.2% in 1997 excluding the impact of the Pagoda International restructuring charge. The increase in the selling and administrative expense rate in 1998 was due to a higher mix of retail sales versus wholesale sales as well as a higher level of retail expenses in 1998 compared to 1997.

Interest expense of \$19.4 million in fiscal 1998 decreased from \$21.8 million in fiscal 1997 primarily as a result of lower average borrowings for the year due to positive cash flow provided from operations.

Other expense of \$4.5 million in fiscal 1998 varied from other income of \$.5 million in 1997 as a result of environmental remediation costs of \$2.3 million, and the write-off of certain intangible assets of \$1.9 million.

The Company's tax provision of \$13.9 million in fiscal 1998 represents an effective tax rate of 37.1%. The 1997 tax provision of \$18.7 million includes an \$8.0 million provision for taxes due on the foreign cash to be repatriated as a result of the decision to restructure the Pagoda International marketing division. In addition, fiscal 1997 results include a high level of Pagoda International losses on which no tax benefit was recorded. See Note 5 to the consolidated financial statements for a further explanation and a reconciliation of the effective tax rates to the statutory rates.

1997 Compared to 1996

Brown Group, Inc.'s net sales of \$1.567 billion in fiscal 1997 were 3% higher than the \$1.525 billion in fiscal 1996. The increased sales reflect higher sales at Famous Footwear which more than offset lower sales within the wholesale operations and at Pagoda International. A net loss of \$20.9 million in fiscal 1997 compares to net earnings of \$20.3 million in fiscal 1996. The net loss in fiscal 1997 includes \$45.6 million of Pagoda International restructuring charges and operating losses compared to an operating loss of \$5.7 million incurred in fiscal 1996. In the third quarter of 1997, the Company announced the decision to substantially reduce its investment in the Pagoda International marketing division as a result of excessive inventories and increasing losses. Excluding the Pagoda International results and the aftertax loss of \$1.5 million incurred on the sale of Famous Footwear's fixtures manufacturing business, net earnings of the core businesses were \$26.2 million in fiscal 1997 compared to \$26.0 million in fiscal 1996. Results for fiscal 1996 reflect a reversal of \$2.3 million of a tax valuation reserve related to the Company's deferred tax assets as well as an aftertax LIFO recovery of \$2.6 million related to the liquidation of inventories at the Company's closed domestic facilities.

Famous Footwear's net sales increased 9% in fiscal 1997 to \$849.9 million with a same-store sales increase of 1.9%. The increased sales were the result of improved store productivity and the addition of 21 net new stores. During the year, 60 stores were opened and 39 stores were closed. Operating earnings for fiscal 1997 increased 28% to \$32.0 million as a result of increased sales combined with continued improvement in the leveraging of the expense base. In fiscal 1997, Famous Footwear's fixture manufacturing business was sold and a \$2.5 million pretax loss was incurred on the sale. The fixtures operation, which had annual sales in 1997 of \$21 million, had incurred net losses between \$1.0 and \$2.5 million over the past several years, depressing Famous Footwear's earnings. Excluding the loss provision on the sale and operating losses at the fixtures operation, Famous Footwear's operating earnings in fiscal 1997 were \$37.8 million.

Net sales from the Company's wholesale operations — the Brown Branded, Pagoda and Canadian Wholesale divisions — decreased 3% during fiscal 1997 to \$448.4 million. Operating earnings were \$32.0 million compared to \$33.7 million in fiscal 1996, which included a \$4.0 million LIFO credit from the liquidation of remaining manufactured inventories within the Brown Branded division. Improved operating earnings resulted from improved margins and tightly controlled operating expenses.

Net sales for the Company's Naturalizer Retail division of \$181.6 million were 2% higher than in 1996. Same-store sales decreased .9% for the United States stores but increased 5.2% for the Canadian stores in fiscal 1997. The total number of stores in operation in the United States at the end of fiscal 1997 was 341 representing a net decrease of 5 stores. The Canadian operations had a net addition of 7 Naturalizer stores in 1997, resulting in 123 stores in operation. Operating earnings for the Naturalizer Retail division were \$2.3 million in 1997 which represents a decrease of 12% from 1996. The lower operating earnings were a result of higher operating costs within the domestic operations.

Consolidated gross profit as a percent of sales of 36.9% in 1997 was down slightly from 37.2% in 1996. Excluding the Pagoda International restructuring charge impact of \$14.7 million, the gross profit as a percent of sales increased to 37.9% due to higher margins at Famous Footwear and the core wholesale operations and a higher mix of retail sales versus wholesale sales.

Selling and administrative expenses as a percent of sales in 1997 increased to 35.7% from 34.2% in 1996. Selling and administrative expenses as a percent of sales were 35.2% excluding the restructuring charge impact of \$7.3 million. The increase in 1997 reflects a higher expense rate from advertising expenditures within the wholesale operations and the effect of a greater mix of retail sales.

Interest expense increased to \$21.8 million in fiscal 1997 from \$19.3 million in fiscal 1996 primarily due to having a full year impact of higher rate debt from the Company's debt repositioning in October 1996. The impact of the higher average borrowing rate on interest expense was slightly offset by the lower average borrowings resulting from the positive cash flow provided by operations.

Other income of \$.5 million in fiscal 1997 consists primarily of royalty income and is offset by the \$1.0 million impact resulting from the Pagoda International restructuring charge recorded within other income. Other income in fiscal 1996 was \$1.3 million.

The Company's tax provision of \$18.7 million in fiscal 1997 includes an \$8.0 million provision for taxes due on the foreign cash to be repatriated as a result of the decision to restructure the Pagoda International marketing division. A tax provision was reflected in fiscal 1997 even with the consolidated pre-tax loss, as no tax benefit was recorded on the Pagoda International losses.

Management's Discussion and Analysis of Operations and Financial Condition

Pagoda International Restructuring

In the third quarter of fiscal 1997, the Company made the decision to reduce its investment in the Pagoda International marketing division in Latin America and Europe as a result of excessive inventories and declining performance. The restructuring plan included the sale of the remaining Brazilian inventory of licensed products and the shift of European inventory ownership and marketing of its licensed footwear to other parties. In addition, plans were developed to repatriate foreign cash previously available to support international operations. The total aftertax charge of \$31.0 million was recorded to cover the costs of this restructuring and consisted of the following:

- Inventory markdowns of \$11.7 million to liquidate excess inventories;
- Charges of \$2.9 million for severance and benefit costs for those employees terminated due to facility closures;
- Charges of \$8.4 million for bad debts, royalty agreement shortfalls and other costs associated with the restructuring; and
- An income tax provision of \$8.0 million associated with the United States taxes owed on the foreign cash anticipated to be repatriated.

In addition to the charge recorded in fiscal 1997, the Company provided \$2.0 million in 1998 for additional costs. As of January 30, 1999, the withdrawal from the division's operations has been substantially completed, as virtually all of the inventory has been sold and all licenses either terminated or assigned to other parties.

A cumulative summary of activity in the restructuring reserve is as follows (in millions):

Initial establishment of reserve	\$31.0
Additional provision recorded in fiscal 1998	2.0
Inventory markdowns	(10.6)
Bad debt write-offs and royalty agreements shortfall	(3.7)
Severance and benefit costs	(1.9)
Utilization of tax provision	(4.0)
Other asset write-offs and costs	(2.1)
Remaining reserve at January 30, 1999	\$10.7

The reserve activity had a \$5.4 million negative cash flow impact in fiscal 1998. This usage was offset by the positive cash flow generated from reduced receiv-

ables and inventories. The remaining reserve will be primarily utilized in fiscal 1999 to cover inventory markdowns, severance, various write-offs of assets and an outstanding cumulative translation adjustment amount. The remaining reserve also includes approximately \$4.0 million for income taxes due on future cash repatriations as cash becomes available. The operating loss to complete the withdrawal from this business in 1999 is expected to be approximately \$1 million. The Company is also contingently liable for approximately \$8 million related to license guarantees, pending Brazilian tax and other assessments and outstanding notes receivable from an Argentinean third party.

Impact of Inflation

The effects of inflation on the Company have been minor over the last several years and are not expected to have a significant impact in the foreseeable future.

Liquidity and Capital Resources

During fiscal 1998, the Company's borrowing level continued to decrease as cash flow from operations more than offset capital expenditures and dividends. As a result, total debt decreased from \$251.0 million at the end of fiscal 1997 to \$197.0 million at the end of fiscal 1998. The Company's ratio of debt-to-total capitalization decreased from 55.8% at the end of fiscal 1997 to 47.6% at the end of fiscal 1998. The ratio was favorably impacted by good management of the balance sheet as well as cash repatriation amounting to approximately \$28 million from Canada and other foreign operations.

Working capital at the end of fiscal 1998 was \$250.9 million, which was \$9.5 million lower than at the end of fiscal 1997. However, the Company's current ratio, the relationship of current assets to current liabilities, increased from 1.9 to 1 at the end of fiscal 1997 to 2.0 to 1 at the end of fiscal 1998. The increase in the current ratio was primarily due to the reduction of outstanding borrowings under the revolving bank Credit Agreement. The reduction in outstanding borrowings was slightly offset by lower receivables and inventories and the increase of current maturities of long-term debt.

Cash provided by operating activities in 1998 was significantly higher than in 1997 as a result of improved earnings as well as decreased inventories and receivables primarily at the Company's wholesale operations.

Cash used by investing activities was primarily for capital expenditures in fiscal 1998 of \$22.7 million compared to \$21.7 million in fiscal 1997. Capital expenditures in fiscal 1998 were primarily for new store openings and remodelings at Famous Footwear and Naturalizer Retail.

The Company's debt agreements contain various covenants which, among other things, require the maintenance of certain financial ratios related to fixed charge coverage and debt-to-total capitalization, establish minimum levels of net worth, and limit the sale of assets and the level of liens and certain investments. In fiscal 1998, the Company amended its revolving bank Credit Agreement and 7.36% Senior Note Agreement, which increased the maximum levels of capital expenditures and extended the revolving bank Credit Agreement by one year. The Company was in compliance with all its covenants during fiscal 1998 and at fiscal year-end, and expects to continue to be in compliance based on current estimates for fiscal 1999. The Company's current borrowing capacity under the revolving bank Credit Agreement is believed to be adequate to fund its operational needs and long-term debt maturities in 1999.

The Company's long-term debt is rated Ba2 by Moody's Investors Service, BB by Standard & Poor's Corporation and BB+ by Fitch Investors Service.

Brown Group paid a dividend of \$.40 per share in fiscal 1998 and \$.85 per share in fiscal 1997. The 1998 dividend marked the 76th year of consecutive quarterly dividends.

Financial Instruments

The market risk inherent in the Company's financial instruments and positions represents the potential loss arising from adverse changes in foreign currency exchange rates and interest rates. To address these risks, the Company enters into various hedging transactions to the extent described below. All decisions on hedging transactions are authorized and executed pursuant to the Company's policies and procedures, which do not allow the use of financial instruments for trading purposes. The Company also is exposed to credit-related losses in the event of nonperformance by counterparties to these financial instruments; however, counterparties to these agreements are major international financial institutions, and the risk of loss due to nonperformance is believed to be minimal.

A discussion of the Company's accounting policies for derivative financial instruments is included in the Summary of Significant Accounting Policies in the Notes to the Consolidated Financial Statements with further disclosure relating to financial instruments included in Note 11.

Foreign Currency Exchange Rates

In the normal course of business, the Company is exposed to foreign currency exchange rate risks as a result of having assets, liabilities and inventory purchase commitments outside the United States. The Company employs an established foreign currency hedging strategy to protect earnings and cash flows from the adverse impact of exchange rate movements. A substantial portion of inventory sourced from foreign countries is purchased in United States dollars and is accordingly not subject to exchange rate fluctuations. However, where the purchase price is to be paid in the foreign currency, the Company enters into foreign exchange contracts or option contracts with maturity periods normally less than one year to reduce its exposures to foreign exchange risk. The level of outstanding contracts during the year is dependent on the seasonality of the Company's business and on demand for footwear from various locations throughout the world. The changes in market value of foreign exchange contracts have a high correlation to the price changes in the currency of the related hedged transactions. The potential loss in fair value of the Company's net currency positions at January 30, 1999 resulting from a hypothetical 10% adverse change in all foreign currency exchange rates would not be material.

Assets and liabilities outside the United States are primarily located in Canada, Hong Kong, Europe and Brazil. The Company's investments in foreign subsidiaries with a functional currency other than the United States' dollar are generally considered long-term, and thus generally are not hedged. In the countries where the economy is deemed to be hyperinflationary or operations are being liquidated, the Company hedges the local currency denominated assets and liabilities. The net investment in foreign subsidiaries translated into dollars using the year-end exchange rates was approximately \$40 million at January 30, 1999. The potential loss in fair value resulting from a hypothetical 10% adverse change in foreign exchange rates would be approximately \$4 million. Any loss in fair value would be reflected as a cumulative translation adjustment in Other Comprehensive Income and would not impact earnings.

Management's Discussion and Analysis of Operations and Financial Condition

Interest Rates

The Company's financing arrangements include both fixed and variable rate debt in which changes in interest rates will impact the fixed and variable rate debt differently. A change in the interest rate of fixed rate debt will only impact the fair value of the debt whereas a change in the interest rates on the variable rate debt will impact interest incurred and cash flows. The Company had no interest rate derivative instruments outstanding at year-end and has not elected to enter into any derivative instruments based upon cost/benefit analyses.

The revolving bank Credit Agreement, the Company's only variable rate debt, had no outstanding borrowings as of January 30, 1999. A hypothetical 10% adverse change in interest rates on the average outstanding borrowings for fiscal 1998 would not be material to the Company's net earnings and cash flows.

At January 30, 1999, the fair value of the Company's total debt is estimated at approximately \$198 million based upon the borrowing rate currently available to the Company for financing arrangements with similar terms and maturities. Market risk is viewed as the potential change in fair value resulting from a hypothetical 10% adverse change in interest rates and would be approximately \$7 million at January 30, 1999.

Year 2000 Compliance

The "Year 2000" issue arises because many computer hardware and software systems, including the Company's, use only two digits to represent the year. As a result, these systems and programs may not accurately calculate dates beyond 1999, which could cause system failures or malfunctions. The Company has established a company-wide Steering Committee, consisting of the Chief Financial Officer, Vice Presidents of the Information Services (IS) functions, internal auditors, executive financial and legal management and other employees, to oversee and manage the Company's Year 2000 project.

A thorough assessment of all of the Company's existing information systems has been completed, and a comprehensive plan to modify or replace all hardware and software information systems that are not Year 2000 compliant has been developed. All systems will be tested to ensure that they will operate properly with respect to dates in the next century. The Company has also assessed the operating systems and equipment used in its distribution centers, offices and other facilities that may contain embedded chips, and that may be Year 2000 sensitive, and will make modifica-

tions where necessary. The plan also includes communicating with significant business partners to determine their state of readiness for the Year 2000.

With respect to its internal information systems, as of January 30, 1999, the Company has substantially completed the modification or replacement and testing of the information and operating systems used in its footwear wholesaling and sourcing operations, and its financial systems. The Company's Naturalizer Retail division is modifying its ongoing systems and installing new in-store systems, which includes replacing all of its point-of-sale registers. The new Year 2000 compliant registers and in-store systems have been installed, and the remaining modification work and testing has been substantially completed in early 1999. The Famous Footwear retail division has completed the modification of its ongoing systems, and is also replacing its in-store systems. Testing of the modified and new store systems is beginning in the first quarter of 1999 and is expected to be completed by the end of the second quarter. The new in-store systems are expected to be installed in all stores by mid-1999. For all of the Company's divisions, the balance of 1999 will be used for additional testing and correction of any problems that may arise.

The Company relies on independent business partners to provide various products and services. One of the most significant groups of partners is the independently owned and operated factories, primarily in China and Brazil, from which the Company purchases footwear for its wholesale and retail operations. Based on communications with representatives of and on-site visits to these factories, the Company has determined that the use of date-sensitive technology in their production processes is relatively low. Nevertheless, the Company is continuing to review the assessment, remediation, and test plans of these factories to attempt to determine whether they can be relied on as suppliers going forward. In addition, the Company has been in contact with footwear companies that provide Famous Footwear with the majority of its products, banks, benefit plan providers, transportation providers and others who supply goods and services to it. Communications with these partners are continuing in order to obtain as much assurance as possible that they will be compliant. However, there can be no assurance that these partners' Year 2000 remediation efforts will be wholly successful. Nor can there be assurance that third parties not contacted will not have problems that could materially adversely affect the Company's business, operations and financial condition.

The Company believes that the most reasonably likely Year 2000 worst case scenario is that its suppliers of footwear, for both its wholesale and retail businesses, would not be able to provide an uninterrupted flow of products due to their own or their suppliers' systems failures or as a result of disruptions in utility or other government services. The Company has not yet developed contingency plans for this scenario, but intends to continue to monitor and evaluate the state of readiness of these suppliers. By mid-1999 the Company will determine which suppliers appear to be at risk of noncompliance, and will attempt to arrange for alternative sources of footwear from its large and diverse group of suppliers. The Company may also consider accelerating purchases of inventory to reduce this risk. The Company believes that there is adequate footwear producing capacity available to allow for the use of alternate sources or accelerated purchases. The Company also believes that if there is a disruption in the flow of footwear it will be short-term in nature. Nevertheless, there can be no assurance that the Company can accurately and fully anticipate the level of disruption that may occur.

The Company's wholesale division customers are department stores, mass-merchants and numerous other footwear retailers. The Company is communicating with its significant retail customers through which it processes transactions electronically using Electronic Data Interchange (EDI) technology to attempt to determine their ability to continue to conduct business in this manner. The Company has adopted the Year 2000 compliant version of EDI, and plans to convert to the new version and perform tests directly with its applicable retail customers throughout 1999. As a contingency plan, if a customer is unable to continue to process transactions through EDI, it is expected that manual procedures could be implemented. The Company intends to continue to monitor and assess the EDI and the general state of Year 2000 readiness of its major retail customers. A Year 2000 failure by a major retail customer could have a materially adverse effect on the Company.

Management estimates that the non-incremental internal IS staff and outside consultant costs of the Company's Year 2000 efforts will total approximately \$1.6 million. Through January 1999, approximately \$1.4 million of this total has been incurred. In addition,

the cost for new purchased or leased hardware and software that will both upgrade the functionality and operating efficiency of store and financial systems, and result in Year 2000 compliance, is expected to be approximately \$15 million. All expenditures related to the Company's Year 2000 project are expected to be funded through operating cash flows. The costs of new purchased and leased systems will be expensed over the next several years. All costs related to modifying systems are being expensed as incurred.

The costs and anticipated completion dates for Year 2000 modifications and the risks associated with the Year 2000 issues are based on management's best estimates utilizing numerous assumptions of future events. There can be no guarantee that these estimates will be achieved and actual results could differ materially from those anticipated. Factors that may cause such material differences include, but are not limited to, the availability and cost of personnel trained in this area, the ability to locate and correct all relevant computer code and systems, the cooperation and remediation success of the Company's suppliers (and their suppliers), and the ability to correctly anticipate risks and implement suitable contingency plans in the event of systems failures at the Company or its suppliers and customers (and their suppliers and customers).

Environmental Matters

The Company is involved in environmental remediation and ongoing compliance at several sites, including its closed New York tannery and at its owned facility in Colorado. In addition, various federal and state authorities have identified the Company as a potentially responsible party for remediation at certain landfills from the sale or disposal of solvents and other by-products from the closed tannery and shoe manufacturing facilities. While the Company currently operates no domestic manufacturing facilities, prior operations included numerous manufacturing and other facilities for which the Company may have responsibility under various environmental laws for the remediation of conditions that may be identified in the future. At January 30, 1999, the accrued environmental liabilities for all sites total approximately \$4.2 million. See Note 14 to the consolidated financial statements for further discussion on specific properties.

Safe Harbor Statement: This Annual Report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Actual results could differ materially from those projected as they are subject to various risks and uncertainties. These include general economic conditions, competition, consumer apparel and footwear trends, and political and economic conditions in Brazil and China, which are significant footwear sourcing countries. These factors are listed and further discussed in the Company's Annual Report on Form 10-K.

Five-Year Summary

Thousands, except per share amounts	1998 (52 weeks)	1997 (52 weeks)	1996 (52 weeks)	1995 (53 weeks)	1994 (52 weeks)
Operations					
Net sales	\$ 1,538,530	\$ 1,567,202	\$ 1,525,052	\$ 1,455,896	\$ 1,461,637
Cost of goods sold	925,190	988,530	958,288	948,925	949,374
Gross profit	613,340	578,672	566,764	506,971	512,263
Selling and administrative expenses	551,877	559,536	521,553	494,098	448,827
Interest expense	19,383	21,756	19,327	15,969	15,785
Other expense (income), net	4,477	(452)	(1,341)	1,630	(12,320)
Earnings (loss) from continuing operations before income taxes	37,603	(2,168)	27,225	(4,726)	59,971
Income tax (provision) benefit	(13,934)	(18,728)	(6,910)	5,423	(26,405)
Earnings (loss) from continuing operations	23,669	(20,896)	20,315	697	33,566
Earnings from discontinued operations, net of income taxes	—	—	—	—	1,282
Credit for disposal of discontinued operations, net of income taxes	—	—	—	2,600	4,550
Net earnings (loss)	\$ 23,669	\$ (20,896)	\$ 20,315	\$ 3,297	\$ 39,398
Returns from continuing operations:					
Return on net sales	1.5%	(1.3%)	1.3%	0.1%	2.3%
Return on beginning shareholders' equity	11.9%	(8.8%)	8.8%	0.3%	14.4%
Return on average invested capital	5.3%	(4.2%)	4.1%	0.2%	6.5%
Dividends paid	\$ 7,223	\$ 15,323	\$ 17,956	\$ 23,325	\$ 28,610
Capital expenditures	22,747	21,727	21,044	26,939	32,531
Per Common Share					
Basic earnings (loss) from continuing operations	\$ 1.34	\$ (1.19)	\$ 1.16	\$.04	\$ 1.93
Basic net earnings (loss)	1.34	(1.19)	1.16	.19	2.27
Diluted earnings (loss) from continuing operations	1.32	(1.19)	1.15	.04	1.90
Diluted net earnings (loss)	1.32	(1.19)	1.15	.19	2.23
Dividends paid	.40	.85	1.00	1.30	1.60
Shareholders' equity	11.95	11.04	13.19	12.92	13.90
Financial Position					
Receivables, net	\$ 67,815	\$ 77,355	\$ 90,246	\$ 86,417	\$ 98,079
Inventories, net	362,274	380,177	398,803	342,282	322,029
Working capital	250,939	260,437	301,020	209,399	259,178
Property and equipment, net	82,178	82,744	85,380	87,720	92,904
Total assets	655,232	694,988	722,375	661,056	636,515
Long-term debt and capitalized lease obligations	172,031	197,027	197,025	105,470	133,213
Shareholders' equity	217,174	199,190	237,037	231,636	249,727
Average common shares outstanding – Basic	17,692	17,591	17,531	17,483	17,374
Average common shares outstanding – Diluted	17,943	17,841	17,725	17,637	17,653

All data presented reflects the fiscal year ended on the Saturday nearest to January 31.

Consolidated Balance Sheets

Thousands, except number of shares and per share amounts

	January 30, 1999	January 31, 1998
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 45,532	\$ 50,136
Receivables, net of allowance of \$9,820 in 1998 and \$9,925 in 1997	67,815	77,355
Inventories, net of adjustment to last-in, first-out cost of \$13,424 in 1998 and \$15,617 in 1997	362,274	380,177
Deferred income taxes	9,381	14,900
Prepaid expenses and other current assets	12,381	15,962
Total Current Assets	497,383	538,530
Prepaid pension costs	34,825	34,388
Other assets	40,846	39,326
Property and equipment, net	82,178	82,744
	\$ 655,232	\$ 694,988
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities		
Notes payable	\$ —	\$ 54,000
Trade accounts payable	124,921	118,907
Employee compensation and benefits	36,935	33,256
Other accrued expenses	53,146	59,935
Income taxes	6,442	11,995
Current maturities of long-term debt	25,000	—
Total Current Liabilities	246,444	278,093
Other Liabilities		
Long-term debt, including capitalized lease obligations	172,031	197,027
Deferred income taxes	6,086	6,817
Other liabilities	13,497	13,861
Total Other Liabilities	191,614	217,705
Shareholders' Equity		
Preferred stock, \$1.00 par value, 1,000,000 shares authorized; no shares outstanding	—	—
Common stock, \$3.75 par value, 100,000,000 shares authorized; 18,168,340 and 18,049,327 shares outstanding	68,131	67,685
Additional capital	48,243	47,036
Unamortized value of restricted stock	(4,058)	(4,358)
Accumulated other comprehensive loss	(8,842)	(8,427)
Retained earnings	113,700	97,254
Total Shareholders' Equity	217,174	199,190
	\$ 655,232	\$ 694,988

See notes to consolidated financial statements.

Consolidated Earnings

Thousands, except per share amounts	1998	1997	1996
Net Sales	\$1,538,530	\$1,567,202	\$1,525,052
Cost of goods sold	925,190	988,530	958,288
Gross profit	613,340	578,672	566,764
Selling and administrative expenses	551,877	559,536	521,553
Interest expense	19,383	21,756	19,327
Other expense (income), net	4,477	(452)	(1,341)
Earnings (Loss) Before Income Taxes	37,603	(2,168)	27,225
Income tax provision	(13,934)	(18,728)	(6,910)
Net Earnings (Loss)	\$ 23,669	\$ (20,896)	\$ 20,315
Basic Net Earnings (Loss) Per Common Share	\$ 1.34	\$ (1.19)	\$ 1.16
Diluted Net Earnings (Loss) Per Common Share	\$ 1.32	\$ (1.19)	\$ 1.15

See notes to consolidated financial statements.

Consolidated Cash Flows

Thousands	1998	1997	1996
Operating Activities:			
Net earnings (loss)	\$23,669	\$(20,896)	\$20,315
Adjustments to reconcile net earnings (loss) to net cash provided by operating activities:			
Depreciation and amortization	26,943	26,686	25,886
Loss on disposal or impairment of facilities and equipment	961	1,475	655
Provision for losses on accounts receivable	2,772	5,145	5,982
Changes in operating assets and liabilities:			
Receivables	6,768	7,746	(10,256)
Inventories	17,903	18,626	(56,521)
Prepaid expenses and other current assets	9,100	6,178	4,541
Trade accounts payable and accrued expenses	2,904	16,349	17,221
Income taxes	(5,553)	7,990	(330)
Other, net	(6,587)	(10,615)	(4,223)
Net Cash Provided by Operating Activities	78,880	58,684	3,270
Investing Activities:			
Capital expenditures	(22,747)	(21,727)	(21,044)
Proceeds from sales of fixed assets	58	401	1,414
Net Cash Used by Investing Activities	(22,689)	(21,326)	(19,630)
Financing Activities:			
Decrease in short-term notes payable	(54,000)	(8,000)	(50,000)
Debt issuance costs	—	(678)	(3,714)
Principal payments of long-term debt and capitalized leases	—	(2,000)	(8,450)
Proceeds from issuance of long-term debt	—	—	100,000
Proceeds from issuance of common stock	428	93	108
Dividends paid	(7,223)	(15,323)	(17,956)
Net Cash (Used) Provided by Financing Activities	(60,795)	(25,908)	19,988
(Decrease) Increase in Cash and Cash Equivalents	(4,604)	11,450	3,628
Cash and Cash Equivalents at Beginning of Year	50,136	38,686	35,058
Cash and Cash Equivalents at End of Year	\$45,532	\$50,136	\$38,686

See notes to consolidated financial statements.

Consolidated Shareholders' Equity

Thousands, except number of shares and per share amounts	Common Stock		Additional Capital	Unamortized Value of Restricted Stock	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Shareholders' Equity
	Shares	Dollars					
Balance February 3, 1996	17,930,977	\$67,242	\$46,015	\$(7,822)	\$(4,913)	\$131,114	\$231,636
Net earnings						20,315	20,315
Currency translation adjustment					480		480
Comprehensive income							20,795
Dividends (\$1.00 per share)						(17,956)	(17,956)
Stock issued under employee benefit plans	6,500	24	84				108
Stock issued under restricted stock plan, net	32,500	121	211	(332)			
Amortization of deferred compensation under restricted stock plan				2,454			2,454
Balance February 1, 1997	17,969,977	\$67,387	\$46,310	\$(5,700)	\$(4,433)	\$133,473	\$237,037
Net loss						(20,896)	(20,896)
Currency translation adjustment					(3,994)		(3,994)
Comprehensive loss							(24,890)
Dividends (\$.85 per share)						(15,323)	(15,323)
Stock issued under employee benefit plans	6,350	24	69				93
Stock issued under restricted stock plan, net	73,000	274	657	(931)			
Amortization of deferred compensation under restricted stock plan				2,273			2,273
Balance January 31, 1998	18,049,327	\$67,685	\$47,036	\$(4,358)	\$(8,427)	\$97,254	\$199,190
Net earnings						23,669	23,669
Currency translation adjustment					(415)		(415)
Comprehensive income							23,254
Dividends (\$.40 per share)						(7,223)	(7,223)
Stock issued under employee benefit plans	27,138	102	326				428
Stock issued under restricted stock plan, net	91,875	344	881	(1,225)			
Amortization of deferred compensation under restricted stock plan				1,525			1,525
Balance January 30, 1999	18,168,340	\$68,131	\$48,243	\$(4,058)	\$(8,842)	\$113,700	\$217,174

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Note 1: *Summary of Significant Accounting Policies*

Organization

Brown Group, Inc., (the "Company") founded in 1878, is a footwear retailer and wholesaler. The Company provides a broad offering of branded, licensed and private label casual, athletic and dress footwear products to women, children and men. Footwear is sold at a variety of price points through multiple distribution channels both domestically and internationally. The Company currently operates 1,289 retail shoe stores in the United States and Canada under the Famous Footwear, Naturalizer® and F.X. LaSalle® names. In addition, through its Brown Branded, Brown Shoe Sourcing, Pagoda and Canadian Wholesale divisions, the Company designs, sources and markets footwear to retail stores domestically and internationally, including department stores, mass merchandisers and specialty shoe stores. In 1998, approximately 68% of the Company's sales were at retail, compared to 66% in 1997 and 63% in 1996. See Note 6 for additional information regarding the Company's business segments.

Consolidation

The consolidated financial statements include the accounts of Brown Group, Inc. and its majority-owned subsidiaries. Significant intercompany accounts and transactions have been eliminated in consolidation.

Accounting Period

The Company's fiscal year is the 52 or 53-week period ending the Saturday nearest to January 31. Fiscal years 1998, 1997 and 1996 ended on January 30, 1999, January 31, 1998, and February 1, 1997, respectively. Fiscal years 1998, 1997 and 1996 each included 52 weeks.

Use of Estimates

The preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Cash and Cash Equivalents

The Company considers all short-term investments with maturities of three months or less to be cash equivalents.

Inventories

All inventories are valued at the lower of cost or market, with 92% of consolidated inventories using the last-in, first-out (LIFO) method.

Computer Software Costs

In fiscal 1998, the Company adopted AICPA Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use," which requires the capitalization of certain costs, including internal payroll costs, incurred in connection with the development or acquisition of software for internal use. The adoption of this standard resulted in an increase in net earnings of approximately \$1.3 million or \$.07 per diluted share for fiscal 1998. No restatement of prior year results was required.

Property and Equipment

Property and equipment are stated at cost. Depreciation and amortization of property and equipment are provided over the estimated useful lives of the assets, or the remaining term of leases where applicable, using the straight-line method.

Pre-opening and Closing Expenses

Pre-opening expenses of new facilities are charged to operations when incurred. Costs of closing facilities, including capital asset disposition losses, lease termination costs, and inventory liquidation costs, are accrued when management makes the decision to close such facilities.

Income Taxes

Provision is made for the tax effects of timing differences between financial and tax reporting. These differences relate principally to depreciation, employee benefit plans, bad debt reserves and inventory.

Earnings Per Share

Basic earnings per share is calculated using only the outstanding shares of common stock. Diluted earnings per share is calculated using all outstanding shares, unvested restricted stock and the dilutive effect, if any, of stock options.

Comprehensive Income

In fiscal 1998, the Company adopted Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" (SFAS No. 130), which reports Comprehensive Income and its components within the Statement of Consolidated Shareholders' Equity. Comprehensive Income represents the change in shareholders' equity during a period from transactions and other events and circumstances from nonowner sources. It includes all changes in equity except those resulting from investments by owners and distributions to owners. Accumulated Other Comprehensive Loss for the Company is composed solely of cumulative foreign currency translation adjustments.

Notes to Consolidated Financial Statements

Translation of Foreign Currencies

Assets and liabilities of subsidiaries, other than those located in highly inflationary countries, are translated at the rate of exchange in effect on the balance sheet date; income and expenses are translated at the average rates of exchange prevailing during the year. The related translation adjustments are reflected in the Accumulated Other Comprehensive Loss section of the Statement of Consolidated Shareholders' Equity. Foreign currency gains and losses resulting from transactions and the translation of financial statements of subsidiaries in highly inflationary countries are included in results of operations.

Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees," and, accordingly recognizes compensation expense related to stock appreciation units and restricted stock grants. No compensation expense is recorded for stock options granted at market value. The Company has elected to apply the provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" (SFAS No. 123), by making pro forma disclosures of net earnings and earnings per share to reflect the fair value of stock options as if SFAS No. 123 had been adopted.

Financial Instruments

The Company's policy is to use financial derivatives only to manage exposure to fluctuations in interest and foreign currency exchange rates.

Gains and losses on contracts that hedge specific foreign currency commitments, which are primarily for inventory purchases, are deferred and included in the basis of the transaction when it is consummated. Material gains and losses on forecasted inventory purchases are recorded in income in the period the value of the contract changes. Gains and losses on contracts which hedge foreign currency assets or liabilities in highly inflationary economies are recognized in income as incurred.

Gains and losses realized and premiums paid on interest rate hedges and foreign currency options, are deferred and amortized to interest expense over the life of the underlying hedged instrument, or immediately if the underlying hedged instrument is settled.

Note 2: Earnings Per Share

The following table sets forth the computation of basic and diluted earnings (loss) per share (in thousands except per share amounts):

	1998	1997	1996
Numerator:			
Net earnings (loss) – Basic and Diluted earnings (loss) per share	\$ 23,669	\$(20,896)	\$20,315
Denominator:			
Denominator for basic earnings (loss) per share	17,692	17,591	17,531
Dilutive effect of unvested restricted stock and stock options	251	—	194
Denominator for diluted earnings (loss) per share	17,943	17,591	17,725
Basic earnings (loss) per share	\$ 1.34	\$ (1.19)	\$ 1.16
Diluted earnings (loss) per share	\$ 1.32	\$ (1.19)	\$ 1.15

The fiscal 1997 denominator for diluted earnings (loss) per share excludes the potential effect of dilutive securities in accordance with SFAS No. 128 because the inclusion of such shares in the computation are anti-dilutive in a period in which a loss was recognized.

Note 3: Retirement and Other Benefit Plans

The Company's pension plan covers substantially all full-time United States employees. Under the plan, salaried, management and certain hourly employees' pension benefits are based on the employee's highest consecutive five years of compensation during the ten years before retirement; hourly employees' and union members' benefits are based on stated amounts for each year of service. The Company's funding policy for all plans is to make the minimum annual contributions required by applicable regulations.

In addition to providing pension benefits, the Company sponsors unfunded defined benefit postretirement health and life insurance plans that cover both salaried employees who had become eligible for benefits by January 1, 1995, and hourly employees. The postretirement health care plans are offered on a shared-cost basis only to employees electing early retirement. This coverage ceases when the employee reaches age 65 and becomes eligible for Medicare. The retirees' contributions are adjusted annually and the Company intends to continue to increase retiree contributions in the future. The life insurance plans provide coverage ranging from \$1,000 to \$38,000 for qualifying retired employees.

The following table sets forth the plans' changes in benefit obligations and plan assets and amounts recognized in the Company's Consolidated Balance Sheets at January 30, 1999 and January 31, 1998 (in thousands):

	Pension Benefits		Other Postretirement Benefits	
	1998	1997	1998	1997
Net benefit obligation at beginning of year	\$100,275	\$ 91,209	\$ 6,887	\$ 7,779
Service cost	4,009	3,494	4	4
Interest cost	7,300	6,876	447	523
Plan participants' contributions	—	—	380	414
Plan amendments	1,225	—	—	—
Actuarial (gain) loss	16,101	5,743	164	(283)
Gross benefits paid	(8,006)	(7,047)	(1,191)	(1,550)
Net benefit obligation at end of year	\$120,904	\$100,275	\$ 6,691	\$ 6,887
Fair value of plan assets at beginning of year	\$146,722	\$124,793	\$ —	\$ —
Actual return on plan assets	18,960	28,862	—	—
Employer contributions	31	114	811	1,136
Plan participants' contributions	—	—	380	414
Gross benefits paid	(8,006)	(7,047)	(1,191)	(1,550)
Fair value of plan assets at end of year	\$157,707	\$146,722	\$ —	\$ —
Funded status at end of year	\$ 36,803	\$ 46,447	\$ (6,691)	\$ (6,887)
Unrecognized net actuarial gain	(2,520)	(10,845)	(1,589)	(2,692)
Unrecognized prior service cost	542	(667)	(2)	(11)
Unrecognized net transition asset	—	(547)	—	—
Net amount recognized at end of year	\$ 34,825	\$ 34,388	\$ (8,282)	\$ (9,590)
Amounts recognized in the consolidated balance sheets consist of:				
Prepaid benefit cost	\$ 41,849	\$ 39,824	\$ —	\$ —
Accrued benefit cost	(7,024)	(5,436)	(8,282)	(9,590)
Net amount recognized at end of year	\$ 34,825	\$ 34,388	\$ (8,282)	\$ (9,590)

Net periodic benefit cost (income) for 1998, 1997 and 1996 included the following components (in thousands):

	Pension Benefits			Other Postretirement Benefits		
	1998	1997	1996	1998	1997	1996
Service cost	\$ 4,009	\$ 3,494	\$ 3,633	\$ 4	\$ 4	\$ 36
Interest cost	7,300	6,876	7,650	447	523	568
Expected return on assets	(11,884)	(10,759)	(12,452)	—	—	—
Amortization of:						
Actuarial (gain) loss	—	—	203	(939)	(1,321)	(1,601)
Prior service cost	16	74	46	(9)	(31)	—
Transition asset	(547)	(635)	(781)	—	—	—
Settlement cost	700	—	1,507	—	—	—
Total net periodic benefit income	\$ (406)	\$ (950)	\$ (194)	\$ (497)	\$ (825)	\$ (997)

Notes to Consolidated Financial Statements

	Pension Benefits		Other Postretirement Benefits	
	1998	1997	1998	1997
Weighted-average assumptions:				
Discount rate	6.25%	7.00%	6.25%	7.00%
Expected return on plan assets	9.50%	9.50%	n/a	n/a
Rate of compensation increase	4.50%	4.50%	n/a	n/a

For measurement purposes, a 6.0% annual rate of increase in the per capita cost of covered health care benefits was assumed for 1998. The rate was assumed to decrease gradually to 5.0% in 2001 and remain at that level thereafter. A one-percentage-point change in assumed health care cost trend rates would not have a material impact on service and interest cost and the postretirement benefit obligation.

The projected benefit obligation, accumulated benefit obligation and fair value of plan assets for pension plans with accumulated benefit obligations in excess of plan assets were \$9.4 million, \$7.0 million and \$0, respectively, as of January 30, 1999 and \$6.5 million, \$5.3 million and \$0 as of January 31, 1998.

The Company's defined contribution 401(k) plan covers salaried, management and certain hourly employees. Company contributions represent a partial matching of employee contributions generally up to a maximum of 3.5% of the employee's salary. The Company's expense for this plan was \$2.8 million in 1998, \$2.0 million in 1997 and \$2.0 million in 1996.

Note 4: *Restructuring Charges*

Included in net loss for fiscal 1997 is an aftertax charge of \$31.0 million for the cost of reducing the Company's investment in the Pagoda International marketing division in Latin America and Europe. The total charge included \$14.7 million as reflected in cost of goods sold for inventory markdowns and anticipated royalty payment shortfalls. Costs for bad debts, severance and other restructuring costs of \$7.3 million are reflected in selling and administrative expenses. Other expense (income) included \$1.0 million primarily for the disposal of fixed assets. In addition, an \$8.0 million provision for income taxes was recorded for the anticipated repatriation of approximately \$23.5 million of foreign cash to the United States. Taxes were not previously provided on these accumulated earnings as they were considered to be permanently reinvested in the Company's inter-

national operations. The total charge resulted in a reduction in earnings of \$1.76 per basic share for fiscal 1997.

In fiscal 1998, the Company provided \$2.0 million, which is reflected in other expense, to cover additional costs. As of January 30, 1999, the withdrawal from the division's operations has been substantially completed, as virtually all of the inventory has been sold and all licenses either terminated or assigned to other parties.

Through January 30, 1999, \$22.3 million of the reserve has been utilized: \$10.6 million for inventory markdowns; \$3.7 million of bad debt write-offs and royalty agreements shortfall; \$1.9 million for severance and benefit costs; \$2.1 million for other asset write-offs and costs; and \$4.0 million on the utilization of tax provisions for cash repatriations made in fiscal 1998.

At January 30, 1999, a \$10.7 million remaining reserve will be primarily utilized in fiscal 1999 to cover inventory markdowns, severance, various asset write-offs and an outstanding cumulative translation adjustment amount. The remaining reserve also includes approximately \$4.0 million for income taxes due on future cash repatriations as cash becomes available.

Note 5: *Income Taxes*

The components of earnings (loss) before income taxes consisted of domestic earnings before income taxes of \$25.2 million, \$14.1 million, and \$10.7 million in 1998, 1997 and 1996, respectively, and foreign earnings (loss) before income taxes of \$12.4 million, \$(16.3) million, and \$16.5 million in 1998, 1997 and 1996, respectively.

The components of income tax expense are as follows (in thousands):

	1998	1997	1996
Federal			
Currently payable	\$ 9,373	\$ 6,158	\$ (523)
Deferred	(662)	7,313	2,323
	8,711	13,471	1,800
State	1,626	614	1,052
Foreign	3,597	4,643	4,058
Total income tax expense	\$13,934	\$18,728	\$6,910

The Company made net tax payments, including federal, state and foreign taxes, of \$13.7 million, \$4.9 million and \$6.8 million in fiscal 1998, 1997 and 1996, respectively.

The differences between the tax expense (benefit) reflected in the financial statements and the amounts calculated at the federal statutory income tax rate of 35% are as follows (in thousands):

	1998	1997	1996
Income taxes at statutory rate	\$13,161	\$ (759)	\$ 9,529
State income taxes, net of federal tax benefit	1,057	399	626
Foreign tax in excess of (less than) domestic rate	(2,913)	574	(1,475)
Foreign operating losses with no benefit provided (A)	2,347	9,390	—
Provision for foreign cash repatriation	—	8,000	—
Reversal of valuation allowance	—	(1,000)	(2,300)
Other	282	2,124	530
	\$13,934	\$18,728	\$ 6,910

(A) Represents foreign operating losses on which no tax benefit will be realized

Significant components of the Company's deferred income tax assets and liabilities are as follows (in thousands):

	January 30, 1999	January 31, 1998
Deferred Tax Assets		
Employee benefits, compensation, and insurance	\$ 7,364	\$ 8,874
Allowance for doubtful accounts	3,289	2,899
Inventory capitalization and inventory reserves	4,185	5,183
Postretirement and postemployment benefit plans	3,525	3,980
Tax credits and loss carryforwards	—	4,319
Other	9,703	10,131
Total deferred tax assets	28,066	35,386
Deferred Tax Liabilities		
Excess depreciation	(1,874)	(4,080)
Retirement plans	(12,319)	(12,140)
LIFO inventory valuation	(8,663)	(9,325)
Other	(1,915)	(1,758)
Total deferred tax liabilities	(24,771)	(27,303)
Net deferred tax asset	\$ 3,295	\$ 8,083

No deferred tax valuation allowance was recorded at the end of fiscal 1998 based on management's assessment that it is more likely than not that all the net deferred tax

assets will be realized through future taxable earnings. In fiscal 1998, the Company utilized all cumulative net operating loss carryforwards and other tax credits for federal income tax purposes.

As of January 30, 1999, no deferred taxes have been provided on the undistributed earnings of the Company's Canadian subsidiary. It is anticipated that no additional United States tax would be incurred if the accumulated Canadian earnings were distributed given the current United States and Canadian income tax rates. The accumulated unremitted earnings from the Company's other foreign subsidiaries, as of January 30, 1999, on which deferred taxes have not been provided are indefinitely reinvested. In the event that these other foreign entities' earnings were distributed, it is estimated that U.S. taxes, net of available foreign tax credits, of approximately \$20.7 million would be due. This liability could be reduced by the \$4.0 million liability remaining from the Pagoda International marketing division restructuring charge. At year-end, management anticipates that the remaining liability will be utilized for income taxes due on future cash repatriations as cash becomes available.

Note 6: *Business Segment Information*

The Company has four reportable segments: Famous Footwear, Wholesale Operations, Naturalizer Retail, and Pagoda International.

Famous Footwear, which represents the Company's largest operating unit, consists of an 827-store chain that sells branded footwear for the entire family.

The Wholesale Operations include the Brown Branded, Brown Shoe Sourcing, Pagoda and Canada Wholesale divisions. These operating units source and market branded, licensed and private label footwear primarily to mass-merchandisers, department stores and company-owned concept stores and Famous Footwear.

The Naturalizer Retail specialty store operations include the 331 Naturalizer Retail stores in the United States and the 131 stores in Canada.

Pagoda International is the Company's international marketing division that sold footwear products to retailers in Europe, Latin America and the Far East. In fiscal 1997, the Company made a decision to reduce its investment in this division as a result of excessive inventories and declining performance; and by the end of 1998, the liquidation of the division was substantially completed.

Notes to Consolidated Financial Statements

The “Other” segment includes the Scholze Tannery business and Corporate assets and general and administrative expenses, which are not allocated to the operating units.

The Company’s reportable segments are operating units that market to different customers and are each managed separately as they distribute their products on a retail or wholesale basis. An operating segment’s performance is evaluated and resources allocated based on operating

profit. Operating profit represents gross profit less general and administrative expenses and other operating income or expense. The accounting policies of the reportable segments are the same as those described in the summary of significant accounting policies. Intersegment sales are generally recorded at a profit to the selling division. All intersegment profits related to inventory on hand at the purchasing division are eliminated against the earnings of the selling division (in thousands):

	Famous Footwear	Wholesale Operations	Naturalizer Retail	Pagoda International	Other	Totals
Fiscal 1998						
External sales	\$ 861,329	\$ 455,935	\$ 187,201	\$ 25,825	\$ 8,240	\$ 1,538,530
Intersegment sales	—	188,969	—	—	—	188,969
Depreciation and amortization	13,902	5,961	3,972	187	2,921	26,943
Operating profit (loss)	47,235	33,480	784	(7,307)	(13,293)	60,899
Operating segment assets	316,628	208,779	76,896	9,872	43,057	655,232
Capital expenditures	14,794	1,968	5,864	—	121	22,747
Fiscal 1997						
External sales	\$ 849,917	\$ 448,369	\$ 181,622	\$ 78,330	\$ 8,964	\$ 1,567,202
Intersegment sales	—	189,463	—	—	—	189,463
Depreciation and amortization	14,697	4,064	3,800	353	3,772	26,686
Restructuring charges	—	—	—	23,000	—	23,000
Operating profit (loss)	32,047	31,951	2,264	(36,583)	(8,604)	21,075
Operating segment assets	322,113	229,767	71,998	31,306	39,804	694,988
Capital expenditures	12,259	3,028	5,860	432	148	21,727
Fiscal 1996						
External sales	\$ 781,319	\$ 463,328	\$ 177,551	\$ 93,149	\$ 9,705	\$ 1,525,052
Intersegment sales	—	174,011	—	—	—	174,011
Depreciation and amortization	14,354	3,912	3,496	182	3,942	25,886
Operating profit (loss)	24,984	33,708	2,564	(5,131)	(10,047)	46,078
Operating segment assets	320,231	240,441	63,723	50,432	47,548	722,375
Capital expenditures	13,750	1,947	4,517	464	366	21,044

	1998	1997	1996
Reconciliation of operating profit to consolidated pretax earnings (loss):			
Total operating profit for reportable segments	\$ 74,192	\$ 29,679	\$ 56,125
Other segment	(13,293)	(8,604)	(10,047)
Interest expense	19,383	21,756	19,327
Non-operating other (income) expense	3,913	1,487	(474)
Total consolidated pretax earnings (loss)	\$ 37,603	\$ (2,168)	\$ 27,225

For geographic purposes, the domestic operations include the wholesale distribution of branded, licensed and private label footwear to a variety of retail customers, and operation of the Famous Footwear and Naturalizer nationwide chains of footwear stores.

The Company’s foreign operations consist of wholesale distribution operations in Europe, Latin America and the Far East, and wholesaling and retailing in Canada. The Far East operations include “first-cost” operations, where footwear is sold at foreign port to customers who then import the footwear into the United States.

A summary of the Company's net sales and long-lived assets by geographic area follows (in thousands):

	1998	1997	1996
Net Sales			
United States	\$1,221,904	\$1,208,878	\$1,137,887
Far East	223,986	242,100	278,371
Canada	74,503	76,716	76,620
Latin America, Europe and Other	25,728	66,583	79,891
Inter-Area Transfers	(7,591)	(27,075)	(47,717)
	\$1,538,530	\$1,567,202	\$1,525,052
Long-Lived Assets			
United States	\$ 127,636	\$ 122,840	\$ 121,522
Far East	12,622	15,332	16,297
Canada	10,894	11,080	12,484
Latin America, Europe and Other	6,697	7,206	7,297
	\$ 157,849	\$ 156,458	\$ 157,600

Long-lived assets consist primarily of property and equipment, prepaid pension costs, goodwill, trademarks and other assets.

Note 7: Inventories

Inventories are valued at the lower of cost or market determined principally by the last-in, first-out (LIFO) method. If the first-in, first-out (FIFO) method had been used, inventories would have been \$13.4 million and \$15.6 million higher at January 30, 1999 and January 31, 1998, respectively.

During fiscal 1996, certain inventories were reduced at Brown Shoe Company and other of the Company's divisions, which resulted in a liquidation of LIFO inventory layers carried at lower costs which prevailed in prior years. On an aftertax basis, the effect of this liquidation was to increase 1996 net income by \$2.6 million.

Note 8: Property and Equipment

Property and equipment consist of the following (in thousands):

	January 30, 1999	January 31, 1998
Land and buildings	\$ 30,338	\$ 29,927
Leasehold improvements	48,128	47,719
Furniture, fixtures and equipment	138,588	134,684
	217,054	212,330
Allowances for depreciation and amortization	(134,876)	(129,586)
	\$ 82,178	\$ 82,744

Under the provisions of Statement of Financial Accounting Standards (SFAS) No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of," charges included in selling and administrative expense for impaired assets of \$.1 million, \$.7 million and \$.7 million were recognized in fiscal 1998, 1997 and 1996, respectively. Fair value was based on estimated future cash flows to be generated by the retail store, discounted at a market rate of interest.

Note 9: Long-Term and Short-Term Financing Arrangements

Long-term debt, including capitalized lease obligations, net of unamortized discounts, consists of the following (in thousands):

	January 30, 1999	January 31, 1998
9.5% Senior Notes due 2006	\$100,000	\$100,000
7.36% Senior Notes, payments of \$10,000 due annually beginning 1999	50,000	50,000
8.45%-8.6% Debentures due 1999	15,000	15,000
7.07%-8.83% Debentures due 2002	18,545	18,543
7.125% Debentures due 2003	10,000	10,000
Capitalized lease obligations	3,486	3,484
	\$197,031	\$197,027

Maturities of long-term debt and capitalized lease obligations for 1999 through 2003 are: 1999—\$25.0 million; 2000—\$10.0 million; 2001—\$10.0 million; 2002—\$28.6 million; and 2003—\$20.0 million.

In fiscal 1996, the Company issued \$100 million in 9.5% Senior Notes due 2006. These Notes are redeemable at the option of the Company, in whole or in part, at any time on or after October 15, 2001.

The Company's revolving bank Credit Agreement, which provides \$155.0 million in committed working capital and letter of credit financing, expires January 2001. Interest on borrowings under the Credit Agreement is at varying rates and at the Company's option based on one of the following: the LIBOR rate, the Bank of America corporate base rate, or the Federal funds rate. A facility fee, .375% at January 30, 1999, based on the Company's leverage ratio is payable on the entire amount of the facility. At January 30, 1999, the Company had no short-term borrowings outstanding and approximately \$16.1 million of letters of credit outstanding under the revolving bank Credit Agreement.

Notes to Consolidated Financial Statements

The Company's Canadian operations maintain uncommitted lines of credit totaling approximately \$5.3 million, with letters of credit outstanding of approximately \$2.2 million as of January 30, 1999.

The Company's debt agreements contain various covenants which, among other things, require the maintenance of certain financial ratios related to fixed charge coverage and total debt to capital, establish minimum levels of net worth, establish limitations on indebtedness, certain types of payments, including dividends, liens and investments, and limit the use of proceeds of asset sales. The 9.5% Senior Notes, the revolving bank Credit Agreement, and the 7.36% unsecured Senior Notes are guaranteed by certain wholly-owned domestic subsidiaries of the Company. In fiscal 1998, the Company amended its revolving bank Credit Agreement and 7.36% Senior Notes which increased the maximum levels of capital expenditures and extended the revolving bank Credit Agreement by one year.

The maximum amount of short-term borrowings under the revolving bank credit arrangements at the end of any month was \$76.0 million in 1998 and \$65.0 million in 1997. The average short-term borrowings during the year were \$21.5 million in 1998 and \$47.0 million in 1997. The weighted average interest rates approximated 7.1% in 1998 and 7.7% in 1997.

Cash payments of interest for fiscal 1998, 1997, and 1996 were \$20.1 million, \$22.5 million, and \$16.5 million, respectively.

Note 10: *Leases*

The Company leases substantially all of its retail locations and certain other equipment and facilities. Over 60 percent of the retail store leases are subject to renewal options for varying periods.

In addition to minimum rental payments, certain of the retail store leases require contingent payments based on sales levels.

Rent expense from continuing operations for operating leases amounted to (in thousands):

	1998	1997	1996
Minimum payments	\$87,473	\$86,132	\$82,829
Contingent payments	2,489	2,665	2,776
	\$89,962	\$88,797	\$85,605

Future minimum payments under noncancelable operating leases with an initial term of one year or more were as follows at January 30, 1999 (in thousands):

	Operating Leases
1999	\$ 81,694
2000	70,121
2001	60,084
2002	48,716
2003	36,757
Thereafter	85,952
Total minimum lease payments	\$383,324

The Company is contingently liable for lease commitments of approximately \$45 million which primarily relate to the Cloth World and Meis specialty retailing chains which were sold.

Note 11: *Financial Instruments*

The Company uses derivative financial instruments to reduce its exposure to market risks from changes in interest rates and foreign exchange rates. The instruments primarily used are foreign exchange contracts, foreign currency options, interest rate swaps, and interest rate futures. The Company is exposed to credit related losses in the event of nonperformance by counterparties to these financial instruments; however, counterparties to these agreements are major international financial institutions, and the risk of loss due to nonperformance is believed to be minimal.

The Company uses foreign exchange instruments to hedge foreign currency transactions on a continuous basis for periods consistent with its committed exposures. The terms of these instruments are generally less than a year. The primary purpose of the foreign currency hedging activities is to protect the Company from the risk that the eventual cash outflows resulting from the purchases of inventory from foreign suppliers will be adversely affected by changes in exchange rates. In addition, the Company also hedges certain foreign currency assets and liabilities through the use of non-deliverable foreign exchange instruments.

The United States dollar equivalent of contractual amounts of the Company's financial instruments consist of the following (in thousands):

	January 30, 1999	January 31, 1998
Deliverable Financial Instruments		
Canadian Dollars	\$12,800	\$ 7,000
French Francs	8,500	9,100
Italian Lira	5,100	11,700
Other Currencies	1,500	1,500
Non-Deliverable Financial Instruments		
New Taiwanese Dollars	7,800	7,400
Brazilian Real	4,000	13,100
Other Currencies	1,000	2,700
	\$40,700	\$52,500

The unrealized gains or losses related to these instruments, based on dealer-quoted prices, were a \$.3 million loss at January 30, 1999 and a \$.1 million gain at January 31, 1998.

Realized gains and losses on financial instruments used as hedges of inventory purchases are included in the basis of the inventory and are recognized in income as a component of cost of goods sold in the period in which the related inventory is sold. Material gains and losses on financial instruments hedging forecasted purchases are recorded in income in the period the value of the instruments change. Gains and losses on financial instruments which hedge foreign currency assets or liabilities in highly inflationary economies, which are designed to protect earnings, are recognized in income as incurred.

The Company had no interest rate derivative instruments outstanding at January 30, 1999 and January 31, 1998.

Note 12: *Fair Value of Financial Instruments*

The carrying amounts and fair values of the Company's financial instruments at January 30, 1999 and January 31, 1998 are (in thousands):

	1998		1997	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Liabilities				
Long-Term Debt, including current maturities	\$197,031	\$198,475	\$197,027	\$201,321

Carrying amounts reported on the balance sheet for cash, cash equivalents, receivables and notes payable approximate fair value due to the short-term maturity of these instruments.

The fair value of the Company's long-term debt was based upon the borrowing rates currently available to the Company for financing arrangements with similar terms and maturities.

Note 13: *Concentrations of Credit Risk*

Financial instruments which potentially subject the Company to significant concentrations of credit risk consist primarily of cash, cash equivalents and trade accounts receivable.

The Company maintains cash and cash equivalents and certain other financial instruments with various financial institutions. The financial institutions are located throughout the world, and the Company's policy is designed to limit exposure to any one institution or geographic region. The Company's periodic valuations of the relative credit standing of these financial institutions are considered in the Company's investment strategy.

The Company's footwear wholesaling businesses sell primarily to department stores, mass merchandisers, and independent retailers primarily across the United States and Canada. Receivables arising from these sales are not collateralized, however, a portion is covered by documentary letters of credit. Credit risk is affected by conditions or occurrences within the economy and the retail industry. The Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends and other information.

Note 14: *Commitments and Contingencies*

The Company is involved in environmental remediation and ongoing compliance activities at several sites. The Company is remediating a residential area adjacent to owned property in Colorado, under the oversight of Colorado authorities. This residential area has been affected by types of solvents that previously were used at the facility. Monitoring of the residential area continues. The Company also is evaluating remediation alternatives for the owned property. During 1998, the Company incurred charges of \$2.3 million related to this site.

At its closed New York tannery and two associated landfills, the Company has completed its remediation efforts, and in 1995, state environmental authorities reclassi-

Notes to Consolidated Financial Statements

fied the status of the site to one that has been properly closed and that requires only continued maintenance and monitoring over the next 25 years. In addition, various federal and state authorities have identified the Company as a potentially responsible party for remediation at certain landfills from the sale or disposal of solvents and other by-products from the closed tannery and shoe manufacturing facilities.

Based on information currently available, the Company is carrying an accrued liability of \$4.2 million as of January 30, 1999, to complete the clean-up at all sites. The ultimate cost may vary.

While the Company currently operates no domestic manufacturing facilities, prior operations included numerous manufacturing and other facilities for which the Company may have responsibility under various environmental laws for the remediation of conditions that may be identified in the future.

The Company is also involved in legal proceedings and litigation arising in the ordinary course of business. In the opinion of management, after consulting with legal counsel, the outcome of such proceedings and litigation currently pending will not have a materially adverse effect on the Company's results of operations or financial position.

In conjunction with the withdrawal from the Pagoda International business, the Company is contingently liable for the performance of certain successor licensees in Europe and Brazil. In addition, the Company has various tax and other assessments outstanding in Brazil, which currently are being appealed and has outstanding notes receivable from an Argentinean third party from the sale of a portion of the division's business. At January 30, 1999, these outstanding items total approximately \$8 million.

Note 15: *Capital Stock*

Common Stock

The Company's Common Stock has a par value of \$3.75 per share and 100,000,000 shares are authorized. At January 30, 1999 and January 31, 1998, there were 18,168,340 shares and 18,049,327 shares, net of 3,837,557 shares and 3,956,570 shares held in treasury, outstanding, respectively. The stock is listed and traded on the New York and Chicago Stock Exchanges (symbol BG). There were approximately 6800 shareholders of record at April 3, 1999.

The Company has a Shareholder Rights Plan, under which each outstanding share of the Company's common stock carries one Common Stock Purchase Right. The rights may only become exercisable under certain circumstances involving acquisition of the Company's common stock by a person or group of persons without the prior written consent of the Company. Depending on the circumstances, if the rights become exercisable, the holder may be entitled to purchase shares of the Company's common stock or shares of common stock of the acquiring person at discounted prices. The rights will expire on March 18, 2006 unless they are earlier exercised, redeemed or exchanged.

Preferred Stock

The Company has 1,000,000 authorized shares of \$1 par value Preferred Stock. None has been issued.

Note 16: *Stock Option and Stock Related Plans*

The Company has stock option, stock appreciation and restricted stock plans under which certain officers and employees are participants.

All stock options are granted at market value. Stock appreciation units may also be granted in tandem with options. Such units entitle the participant to receive an amount, in cash and/or stock, equal to the difference between the current market value of a share of stock at the exercise date and the option price of such share of stock. The options and appreciation units become exercisable one year from the date of the grant at a rate of 25% per year and are exercisable for up to 10 years from the date of grant. Since the stock appreciation rights are issued in tandem with stock options, the exercise of either cancels the other. As of January 30, 1999, 440,220 additional shares of common stock were available to be granted in the form of options or restricted stock.

The Company has elected to follow Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB 25) and related Interpretations in accounting for its employee stock options instead of the alternative fair value accounting provided for under Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation." Under APB 25, because the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized.

Pro forma information regarding net income and earnings per share is required by SFAS No. 123, and has been determined as if the Company had accounted for its employee stock options under the fair value method of that Statement. The fair value for these options was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted-average assumptions for 1998, 1997 and 1996, respectively: risk-free interest rates of 5.2%, 6.0% and 6.6%; dividend yields of 2.4%, 4.3% and 5.9%; volatility factors of the expected market price of the Company's common stock of .34, .33 and .29; and a weighted-average expected life of the option of 7 years. The weighted average fair value of options granted during 1998, 1997 and 1996 was \$5.81, \$4.35 and \$3.53 per share, respectively.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period. The Company's pro forma information follows (in thousands except for per share amounts):

	1998	1997	1996
Net income (loss) as reported	\$23,669	\$ (20,896)	\$ 20,315
Pro forma net income (loss)	22,641	(21,513)	19,957
Basic earnings (loss) per share as reported	1.34	(1.19)	1.16
Pro forma basic earnings (loss) per share	1.28	(1.22)	1.14
Diluted earnings (loss) per share as reported	1.32	(1.19)	1.15
Pro forma diluted earnings (loss) per share	1.26	(1.22)	1.13

The following summary sets forth the Company's stock option and stock appreciation rights activity for the three years ended January 30, 1999:

	Number of		Weighted Average Exercise Price
	Option Shares	Appreciation Units	
Outstanding February 3, 1996	873,422	67,696	\$ 25
Granted	254,000	64,405	17
Exercised	—	—	—
Terminated	(203,926)	(21,316)	32
Outstanding February 1, 1997	923,496	110,785	22
Granted	501,000	101,488	15
Exercised	(2,000)	—	14
Terminated	(80,578)	—	30
Outstanding January 31, 1998	1,341,918	212,273	19
Granted	371,000	82,724	17
Exercised	(15,250)	(22,330)	15
Terminated	(252,574)	(16,629)	24
Outstanding January 30, 1999	1,445,094	256,038	\$ 17

Following is a summary of stock options outstanding as of January 30, 1999, which have exercise prices ranging from \$14 to \$38:

	Number of Options	Weighted Average Exercise Price	Weighted Average Remaining Life
Options Outstanding:			
Price under \$17	1,242,399	\$16	8
Price \$17 or over	202,695	26	5
	1,445,094	\$17	8
Options Exercisable:			
Price under \$17	373,100	\$15	8
Price \$17 or over	177,320	27	5
	550,420	\$19	7

Notes to Consolidated Financial Statements

At January 31, 1998, 596,294 options with a weighted average exercise price of \$21 were exercisable. At February 1, 1997, 354,121 options with a weighted average exercise price of \$28 were exercisable.

Under the Company's restricted stock program, common stock of the Company may be granted at no cost to certain officers and key employees. Plan participants are entitled to cash dividends and to vote their respective shares. Restrictions limit the sale or transfer of these shares during an eight-year period whereby the restrictions lapse on 50% of these shares after 4 years, 25% after 6 years and the remaining 25% after 8 years. Upon issuance of stock under the plan, unearned compensation equivalent to the market value at the date of grant is charged to shareholders' equity and subsequently amortized to expense over the eight-year restriction period. Restricted shares granted, net of forfeitures, were 91,875, 73,000 and 32,500 in 1998, 1997 and 1996, respectively, and compensation expense was \$1.5 million, \$2.3 million and \$2.5 million in 1998, 1997 and 1996, respectively.

Note 17: *Supplementary Information*

Balance Sheet

Cash equivalents of \$37.7 million and \$37.6 million at January 30, 1999 and January 31, 1998, respectively, are stated at cost which approximates fair value.

Statement of Consolidated Earnings

Advertising costs totaled \$54.9 million, \$61.0 million, and \$55.9 million in 1998, 1997 and 1996, respectively. Other Expense (Income) consisted of the following (in thousands):

	1998	1997	1996
Interest income	\$(1,730)	\$(1,427)	\$(1,202)
Restructuring charges	1,950	1,000	—
Royalty income	(1,377)	(2,127)	(2,702)
Amortization of intangibles	3,488	1,731	1,551
Environmental charges	2,344	—	—
Other, net	(198)	371	1,012
Total	\$ 4,477	\$ (452)	\$(1,341)

Note 18: *Impact of New Accounting Standards*

In June 1998, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133). The statement is effective for the Company beginning fiscal 2000. SFAS 133 requires that all derivative instruments be recorded on the balance sheet at their fair value. Derivatives that are not hedges must be adjusted to fair value through income. If the derivative is a hedge, depending on the nature of the hedge, changes in the fair value of derivatives will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings or recognized in Other Comprehensive Income until the hedged item is recognized in earnings. The ineffective portion of a derivative's change in fair value will be immediately recognized in earnings. The Company has not yet assessed what the impact of SFAS 133 will be on the Company's future earnings or financial position.

Note 19: *Condensed Consolidating Financial Information*

The 9.5% Senior Notes, the revolving bank Credit Agreement, and the 7.36% Senior Notes, discussed in Note 9, are unconditionally and jointly and severally guaranteed by certain wholly-owned domestic subsidiaries of the Company. The non-guarantor subsidiaries are predominantly foreign subsidiaries of the Company. Accordingly, condensed consolidating balance sheets as of January 30, 1999 and January 31, 1998, and the related condensed consolidating statements of earnings and cash flows for each of the three years in the period ended January 30, 1999 are provided. These condensed consolidating financial statements have been prepared using the equity method of accounting in accordance with the requirements for presentation of such information. Management believes that this information, presented in lieu of complete financial statements for each of the guarantor subsidiaries, provides meaningful information to allow investors to determine the nature of the assets held by, and the operations and cash flow of, each of the consolidating groups (in thousands).

Condensed Consolidating Balance Sheet as of January 30, 1999

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Totals
Assets					
Current Assets					
Cash and cash equivalents	\$ 12,186	\$ 4,738	\$ 28,608	\$ —	\$ 45,532
Receivables, net	35,779	10,823	21,213	—	67,815
Inventory, net	52,458	300,009	22,358	(12,551)	362,274
Other current assets	(5,597)	17,456	5,511	4,392	21,762
Total Current Assets	94,826	333,026	77,690	(8,159)	497,383
Other assets	45,723	18,076	11,986	(114)	75,671
Property and equipment, net	15,156	60,200	6,822	—	82,178
Investment in subsidiaries	229,896	38,386	3,811	(272,093)	—
Total Assets	\$385,601	\$449,688	\$100,309	\$(280,366)	\$655,232
Liabilities and Shareholders' Equity					
Current Liabilities					
Notes payable	\$ —	\$ —	\$ —	\$ —	\$ —
Accounts payable	5,745	92,943	26,233	—	124,921
Accrued expenses	27,145	51,023	15,546	(3,633)	90,081
Income taxes	(5,042)	10,913	564	7	6,442
Current maturities of long-term debt	25,000	—	—	—	25,000
Total Current Liabilities	52,848	154,879	42,343	(3,626)	246,444
Long-term debt and capitalized lease obligations	172,031	—	41	(41)	172,031
Other liabilities	20,130	(716)	238	(69)	19,583
Intercompany payable (receivable)	(76,582)	58,029	17,976	577	—
Shareholders' equity	217,174	237,496	39,711	(277,207)	217,174
Total Liabilities and Shareholders' Equity	\$385,601	\$449,688	\$100,309	\$(280,366)	\$655,232

Condensed Consolidating Statement of Earnings for the Fiscal Year Ended January 30, 1999

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Totals
Net Sales	\$262,498	\$1,223,024	\$326,529	\$(273,521)	\$1,538,530
Cost of goods sold	184,622	752,497	261,592	(273,521)	925,190
Gross profit	77,876	470,527	64,937	—	613,340
Selling and administrative expenses	74,129	425,959	53,426	(1,637)	551,877
Interest expense	19,287	5	91	—	19,383
Intercompany interest (income) expense	(14,123)	14,067	56	—	—
Other (income) expense, net	(310)	279	2,871	1,637	4,477
Equity in (earnings) loss of subsidiaries	(24,829)	(5,980)	—	30,809	—
Earnings (Loss) Before Income Taxes	23,722	36,197	8,493	(30,809)	37,603
Income tax provision	(53)	(11,368)	(2,513)	—	(13,934)
Net Earnings (Loss)	\$ 23,669	\$ 24,829	\$ 5,980	\$(30,809)	\$ 23,669

Notes to Consolidated Financial Statements

Condensed Consolidating Statement of Cash Flow for the Fiscal Year Ended January 30, 1999

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Totals
Net Cash Provided (Used) by Operating Activities	\$ 37,645	\$ 51,971	\$ (6,925)	\$ (3,811)	\$ 78,880
Investing Activities:					
Capital expenditures	(837)	(19,717)	(2,193)	—	(22,747)
Other	13	25	20	—	58
Net Cash Used by Investing Activities	(824)	(19,692)	(2,173)	—	(22,689)
Financing Activities:					
Decrease in short-term notes payable	(54,000)	—	—	—	(54,000)
Proceeds from issuance of common stock	428	—	—	—	428
Dividends paid	(7,223)	—	—	—	(7,223)
Intercompany financing	34,712	(34,384)	(4,179)	3,851	—
Net Cash Provided (Used) by Financing Activities	(26,083)	(34,384)	(4,179)	3,851	(60,795)
Increase (Decrease) in Cash and Cash Equivalents	10,738	(2,105)	(13,277)	40	(4,604)
Cash and Cash Equivalents at Beginning of Period	1,448	6,843	41,885	(40)	50,136
Cash and Cash Equivalents at End of Period	\$ 12,186	\$ 4,738	\$ 28,608	\$ —	\$ 45,532

Condensed Consolidating Balance Sheet as of January 31, 1998

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Totals
Assets					
Current Assets					
Cash and cash equivalents	\$ 1,448	\$ 6,843	\$ 41,885	\$ (40)	\$ 50,136
Receivables, net	36,244	9,697	31,414	—	77,355
Inventory, net	62,543	302,339	29,004	(13,709)	380,177
Other current assets	(100)	18,589	7,575	4,798	30,862
Total Current Assets	100,135	337,468	109,878	(8,951)	538,530
Other assets	44,709	17,029	12,088	(112)	73,714
Property and equipment, net	17,192	58,784	6,768	—	82,744
Investment in subsidiaries	233,048	32,406	3,811	(269,265)	—
Total Assets	\$ 395,084	\$ 445,687	\$ 132,545	\$ (278,328)	\$ 694,988
Liabilities and Shareholders' Equity					
Current Liabilities					
Notes payable	\$ 54,000	\$ —	\$ —	\$ —	\$ 54,000
Accounts payable	6,911	81,329	30,667	—	118,907
Accrued expenses	27,004	44,993	21,693	(499)	93,191
Income taxes	2,157	14,027	(4,189)	—	11,995
Total Current Liabilities	90,072	140,349	48,171	(499)	278,093
Long-term debt and capitalized lease obligations	197,027	—	79	(79)	197,027
Other liabilities	20,089	259	399	(69)	20,678
Intercompany payable (receivable)	(111,294)	92,413	22,155	(3,274)	—
Shareholders' equity	199,190	212,666	61,741	(274,407)	199,190
Total Liabilities and Shareholders' Equity	\$ 395,084	\$ 445,687	\$ 132,545	\$ (278,328)	\$ 694,988

***Condensed Consolidating Statement of Earnings for the
Fiscal Year Ended January 31, 1998***

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Totals
Net Sales	\$ 256,031	\$ 1,201,078	\$ 369,735	\$ (259,642)	\$ 1,567,202
Cost of goods sold	180,568	755,729	312,051	(259,818)	988,530
Gross profit	75,463	445,349	57,684	176	578,672
Selling and administrative expenses	71,752	412,221	76,954	(1,391)	559,536
Interest expense	21,512	9	235	—	21,756
Intercompany interest (income) expense	(15,403)	15,368	35	—	—
Other (income) expense, net	(4,655)	1,201	1,435	1,567	(452)
Equity in (earnings) loss of subsidiaries	22,622	23,693	—	(46,315)	—
Earnings (Loss) Before Income Taxes	(20,365)	(7,143)	(20,975)	46,315	(2,168)
Income tax provision	(531)	(15,479)	(2,718)	—	(18,728)
Net Earnings (Loss)	\$ (20,896)	\$ (22,622)	\$ (23,693)	\$ 46,315	\$ (20,896)

***Condensed Consolidating Statement of Cash Flow for the
Fiscal Year Ended January 31, 1998***

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Totals
Net Cash Provided (Used) by Operating Activities	\$23,891	\$29,544	\$ (1,590)	\$ 6,839	\$ 58,684
Investing Activities:					
Capital expenditures	(2,512)	(17,530)	(1,685)	—	(21,727)
Other	386	8	7	—	401
Net Cash Used by Investing Activities	(2,126)	(17,522)	(1,678)	—	(21,326)
Financing Activities:					
Decrease in short-term notes payable	(8,000)	—	—	—	(8,000)
Debt issuance costs	(678)	—	—	—	(678)
Repayments of long-term debt	(2,000)	—	—	—	(2,000)
Proceeds from issuance of common stock	93	—	—	—	93
Dividends paid	(15,323)	—	—	—	(15,323)
Intercompany financing	5,721	(11,489)	14,846	(9,078)	—
Net Cash Provided (Used) by Financing Activities	(20,187)	(11,489)	14,846	(9,078)	(25,908)
Increase (Decrease) in Cash and Cash Equivalents	1,578	533	11,578	(2,239)	11,450
Cash and Cash Equivalents at Beginning of Period	(130)	6,310	30,307	2,199	38,686
Cash and Cash Equivalents at End of Period	\$ 1,448	\$ 6,843	\$41,885	\$ (40)	\$ 50,136

Notes to Consolidated Financial Statements

Condensed Consolidating Statement of Earnings for the Fiscal Year Ended February 1, 1997

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Totals
Net Sales	\$254,764	\$1,155,158	\$401,222	\$ (286,092)	\$1,525,052
Cost of goods sold	179,403	741,203	323,923	(286,241)	958,288
Gross profit	75,361	413,955	77,299	149	566,764
Selling and administrative expenses	72,660	385,320	64,768	(1,195)	521,553
Interest expense	18,897	235	195	—	19,327
Intercompany interest (income) expense	(14,097)	14,131	(34)	—	—
Other (income) expense, net	(4,393)	153	1,555	1,344	(1,341)
Equity in (earnings) of subsidiaries	(17,075)	(8,556)	—	25,631	—
Earnings (Loss) Before Income Taxes	19,369	22,672	10,815	(25,631)	27,225
Income tax (provision) benefit	946	(5,597)	(2,259)	—	(6,910)
Net Earnings (Loss)	\$ 20,315	\$ 17,075	\$ 8,556	\$ (25,631)	\$ 20,315

Condensed Consolidating Statement of Cash Flow for the Fiscal Year Ended February 1, 1997

	Parent	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated Totals
Net Cash Provided (Used) by Operating Activities	\$(24,421)	\$ 27,197	\$ 4,595	\$(4,101)	\$ 3,270
Investing Activities:					
Capital expenditures	(1,551)	(17,338)	(2,155)	—	(21,044)
Other	1,387	4	23	—	1,414
Net Cash Used by Investing Activities	(164)	(17,334)	(2,132)	—	(19,630)
Financing Activities:					
Decrease in short-term notes payable	(50,000)	—	—	—	(50,000)
Debt issuance costs	(3,714)	—	—	—	(3,714)
Repayments of long-term debt	(8,450)	—	—	—	(8,450)
Proceeds from issuance of long-term debt	100,000	—	—	—	100,000
Proceeds from issuance of common stock	108	—	—	—	108
Dividends paid	(17,956)	—	—	—	(17,956)
Intercompany financing	4,758	(12,519)	1,461	6,300	—
Net Cash Provided (Used) by Financing Activities	24,746	(12,519)	1,461	6,300	19,988
Increase (Decrease) in Cash and Cash Equivalents	161	(2,656)	3,924	2,199	3,628
Cash and Cash Equivalents at Beginning of Period	(291)	8,966	26,383	—	35,058
Cash and Cash Equivalents at End of Period	\$ (130)	\$ 6,310	\$30,307	\$ 2,199	\$38,686

Reports on Financial Statements

Management Report on Responsibility for Financial Reporting

The management of Brown Group, Inc. has the responsibility for preparing the accompanying financial statements and for their integrity and objectivity. The statements were prepared in accordance with generally accepted accounting principles, and are not misstated due to material fraud or error. The financial statements include amounts that are based on management's best estimates and judgments. Management also prepared the other information in the annual report and is responsible for its accuracy and consistency with the financial statements.

The Company's financial statements have been audited by Ernst & Young LLP, independent auditors. Management has made available to Ernst & Young LLP all the Company's financial records and related data, as well as the minutes of shareholders' and directors' meetings. Furthermore, management believes that all representations made to Ernst & Young LLP during its audit were valid and appropriate.

The Audit Committee of Brown Group's Board of Directors comprised four outside directors in 1998. The Committee meets regularly with the Company's independent auditors, Ernst & Young LLP, and management. The purpose of these meetings is to review, among other things, the scope and results of the annual audit, the internal audit activities and the system of internal accounting control. To ensure complete independence, Ernst & Young LLP and the internal audit staff have direct access to the Audit Committee without the presence of management to discuss the results of their examinations.

Management of the Company has established and maintains a system of internal control that provides reasonable assurance as to the integrity and reliability of the financial statements, the protection of assets from unauthorized use or disposition, and the prevention and detection of fraudulent financial reporting. The system of internal control provides for appropriate division of responsibility and is documented by written policies and procedures that are communicated to employees with significant roles in the financial reporting process and updated as necessary. The Company maintains an internal auditing program that independently assesses the effectiveness of the internal controls and recommends possible improvements thereto. Management believes that the Company's system of internal control is adequate to accomplish the objectives discussed herein.

Management also recognizes its responsibility for fostering a strong ethical climate so that the Company's affairs are conducted according to the highest standards of personal and corporate conduct. This responsibility is characterized and reflected in the Company's code of conduct, which is published throughout the Company. The code of conduct

addresses, among other things, the necessity of ensuring open communication within the Company; potential conflicts of interest; compliance with all domestic and foreign laws, including those relating to financial disclosure; and the confidentiality of proprietary information. The Company maintains a systematic program to assess compliance with these policies. The results of this compliance program are discussed with the Audit Committee.



Ronald A. Fromm
Chief Executive Officer



Harry E. Rich
Chief Financial Officer

Report of Ernst & Young LLP, Independent Auditors

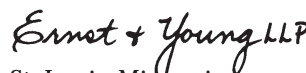
Shareholders and Board of Directors
Brown Group, Inc.

We have audited the accompanying consolidated balance sheets of Brown Group, Inc. as of January 30, 1999 and January 31, 1998, and the related statements of consolidated earnings, shareholders' equity, and cash flows for each of the three years in the period ended January 30, 1999. 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, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Brown Group, Inc. at January 30, 1999 and January 31, 1998, and the consolidated results of its operations and its cash flows for each of the three years in the period ended January 30, 1999 in conformity with generally accepted accounting principles.

As discussed in Note 1 to the consolidated financial statements, in 1998 the Company changed its method of accounting for the costs of computer software developed or obtained for internal use.



St. Louis, Missouri
March 4, 1999

Supplementary Financial Information

Selected Quarterly Information (Unaudited)

Following is a summary of selected quarterly information (in thousands except per share amounts) for fiscal years ended January 30, 1999 and January 31, 1998.

	Quarters			
	First (13 Weeks)	Second (13 Weeks)	Third (13 Weeks)	Fourth (13 Weeks)
1998				
Net Sales	\$ 402,309	\$ 383,618	\$ 411,976	\$ 340,627
Gross Profit	155,324	154,002	163,754	140,260
Net Earnings	3,871	4,295	12,898	2,605
Per Share of Common Stock:				
Net Earnings – Basic	\$.22	\$.24	\$.73	\$.15
Net Earnings – Diluted	.22	.24	.72	.14
Dividends Paid	.10	.10	.10	.10
Market Value:				
High	16	19 ⁷ / ₈	16 ⁷ / ₈	18 ⁷ / ₈
Low	14 ¹ / ₄	15 ⁷ / ₈	12 ⁷ / ₈	15 ⁷ / ₈
1997				
Net Sales	\$ 391,815	\$ 378,823	\$ 433,886	\$ 362,678
Gross Profit	145,833	146,236	155,830	130,773
Net Earnings (Loss)	1,542	3,530	(13,323)	(12,645)
Per Share of Common Stock:				
Net Earnings (Loss) – Basic	\$.09	\$.20	\$ (.76)	\$ (.72)
Net Earnings (Loss) – Diluted	.09	.20	(.76)	(.72)
Dividends Paid	.25	.25	.25	.10
Market Value:				
High	17 ³ / ₄	20	18 ³ / ₈	16 ¹ / ₂
Low	15 ⁵ / ₈	15 ³ / ₄	14 ⁷ / ₈	12 ³ / ₄

Note 1: Results for 1997 include an aftertax charge of \$31.0 million for the restructuring of the Pagoda International marketing division. The net effect on the quarterly results of fiscal 1997 is \$21.0 million in the third quarter and \$10.0 million in the fourth quarter.

Directors' and Officers' Liability Insurance: The New York Business Corporation Act requires that New York corporations provide to their shareholders information regarding any policies of directors' and officers' liability insurance which have been purchased or renewed. Accordingly, notice is hereby given that on October 31, 1998, the Company purchased, for a three-year term, policies of directors' and officers' liability insurance from Federal Insurance Company, a member of the Chubb Insurance Group and National Union Fire Insurance Company. These policies cover all duly elected directors and all duly elected or appointed officers of Brown Group, Inc. and its subsidiary companies. The policy premium for a three-year term is \$312,000. To date, no claims have been paid under any policy of directors' and officers' liability insurance.

Leadership

Operating Executives and Officers

Executive Management

Ronald A. Fromm*

Chairman of the Board,
President, Chief Executive
Officer and President —
Brown Shoe Company

Brian C. Cook*

Executive Vice President and
President — Famous Footwear

Gary M. Rich*

President, Pagoda division

Harry E. Rich*

Executive Vice President and
Chief Financial Officer

David H. Schwartz*

President, Brown Shoe Sourcing
division

Gregory J. Van Gasse*

President, Brown Branded
division

Officers and Operating Management

James W. Anderson

Vice President — Finance,
Pagoda division

Theodore L. Anderson*

Senior Vice President —
Retail Sales and Operations,
Famous Footwear

Carl H. Bengtson

Senior Vice President — Latin
American/European Operations,
Brown Shoe Sourcing division

Donald L. Damask

Senior Vice President —
Marketing, Brown Branded
division

William A. Dandy*

Senior Vice President —
Marketing, Famous Footwear

Earl B. Fischer

Vice President — Information
Systems, Famous Footwear

Robert D. Gibbs

Vice President — Distribution,
Brown Shoe Company

Kenneth W. Gilbertson

President — Canada Wholesale
division

Charles C. Gillman*

Senior Vice President and
Director — Far East Operations,
Brown Shoe Sourcing division

Dennis F. Hadican

Vice President and General
Manager — Westport,
Pagoda division

David E. Hanebrink

Vice President and General
Manager — Men's, Boys' and
Athletic, Pagoda division

Janet M. Hardyman

Vice President — Human
Resources, Famous Footwear

Richard P. Kuether

Vice President — Logistics,
Famous Footwear

J. Martin Lang*

Senior Vice President and
Chief Financial Officer,
Famous Footwear

Sherman H. Lasser

Senior Vice President — Sales,
Brown Branded division

Byron D. Norfleet*

Senior Vice President and
General Manager — Naturalizer
Retail division

Robert D. Pickle

Vice President, General Counsel
and Corporate Secretary

Sharon L. Poston

Vice President and Brand
Director — Naturalizer,
Brown Branded division

James E. Preuss

Director — Human Resources,
Brown Shoe Company

Richard T. Price

Vice President — Management
Information Systems, Brown
Shoe Company

James M. Roe*

Senior Vice President —
Real Estate, Famous Footwear

Andrew M. Rosen*

Senior Vice President and
Treasurer

Daniel F. Ruderer

Vice President — Store Design
and Visual Merchandising,
Famous Footwear

Jeff N. Sanders

Senior Vice President and
General Manager — Life Stride,
Brown Branded division

Mark J. Schauster

Senior Vice President and
Director of Product Development,
Brown Branded division

Richard C. Schumacher*

Vice President and Controller

Paul M. Shapiro

Vice President and General
Manager — Children's and
Children's Better Brands,
Pagoda division

Alan A. Silverstein

Senior Vice President —
Women's, Pagoda division

Mary Sylvia Siverts

Vice President — Public Affairs

Robert E. Stadler, Jr.

Vice President — Finance and
Operations, Brown Shoe
Company

Jean Guy Vaudry

President — Canada Retail
division

George J. Zelinsky*

Senior Vice President and
General Merchandise Manager,
Famous Footwear

Spencer E. Zimmerman

Senior Vice President and
General Manager — Naturalizer,
Brown Branded division

* Member of the Company's
Operating Committee

Board of Directors

Ronald A. Fromm ⁽¹⁾
Chairman of the Board,
President and
Chief Executive Officer

B. A. Bridgewater, Jr.
Retired Chairman of the Board

Joseph L. Bower ^(3,4)
Donald Kirk David Professor,
Chairman of Doctoral Programs
and Director of Research,
Harvard Business School

Julie C. Esrey ^(2,4)
Director of various organizations

Richard A. Liddy ^(1,2,4)
Chairman of the Board, President
and Chief Executive Officer,
GenAmerica Corporation

John Peters MacCarthy ^(2,3)
Retired Chairman of the Board
and Chief Executive Officer,
Boatmen's Trust Company

John D. Macomber
Director of various corporations

William E. Maritz
Chairman of the Board and
former Chief Executive Officer,
Maritz Inc., a motivation, travel,
training, communications and
marketing research services
company

General Edward C. Meyer
Retired Chief of Staff of the
U.S. Army and international
business consultant

Harry E. Rich ⁽¹⁾
Executive Vice President and
Chief Financial Officer

Jerry E. Ritter ^(1,3,4)
Chairman, Clark Enterprises,
Inc., operator of the Kiel Center
Entertainment Complex and the
St. Louis Blues Hockey Club

Effective May 27, 1999: *

- (1) Member of the Executive Committee
- (2) Member of the Audit Committee
- (3) Member of the Compensation Committee
- (4) Member of the Governance and Nominating Committee

* Upon the retirements of Messrs.
Bridgewater, Macomber, Maritz and
Meyer from the Board of Directors

Investor Information

Corporate Headquarters

Brown Group, Inc.
8300 Maryland Avenue
St. Louis, Missouri 63105-3693

Mailing Address:
Post Office Box 29
St. Louis, Missouri 63166-0029

Telephone: (314) 854-4000
Fax: (314) 854-4274
E-mail: info@browngroup.com

Internet Address

<http://www.browngroup.com>


Annual Meeting

11:00 a.m. Central Time
Thursday, May 27, 1999
Brown Group, Inc.
Corporate Headquarters

Number of Employees

11,000

Stock Listed

 Brown Group stock is listed
on the New York Stock
Exchange and the Chicago Stock
Exchange (ticker symbol BG).

Number of Shareholders of Record

6,800

Independent Auditors

Ernst & Young LLP
St. Louis, Missouri

Transfer Agent/Registrar/ Dividend Disbursing Agent

First Chicago Trust Company
of New York
Post Office Box 2500
Jersey City, NJ 07303-2500
(201) 324-0498 or (800) 446-2617
Internet: <http://www.fctc.com>
E-mail: fctc@em.fcncd.com

Dividend Reinvestment Plan

The Dividend Reinvestment Plan
provides a means of automatic
dividend reinvestment and includes
a provision for voluntary investment
of additional cash. For a prospectus
and enrollment form, contact
First Chicago Trust Company.

Direct Deposit of Dividends

Registered shareholders may have
their quarterly dividend checks
deposited directly to their bank
accounts. For more information or
to request an enrollment form, con-
tact First Chicago Trust Company.

Trustee of Debentures/Notes

State Street Bank and Trust
Company of Missouri, N. A.
One Metropolitan Square
Post Office Box 321
St. Louis, Missouri 63166-0321
(314) 206-3020

Additional Information

On the Internet: You can access financial and other information such as significant news releases, Forms 10-K and 10-Q, and product information, on the Internet at <http://www.browngroup.com>

By fax-back: Copies of Brown Group's press releases can be transmitted at no charge via fax by calling "Company News On-Call" at (800) 758-5804 extension 109435.

By calling or writing: You can also request that any of these materials be mailed to you at no charge by calling or writing:

Brown Group, Inc.
Investor Relations
Post Office Box 29
St. Louis, Missouri 63166-0029
(314) 854-4000

On May 27, 1999, shareholders will vote on a proposal recommended by the Board of Directors to change the name of the company to Brown Shoe Company, Inc.

Famous Footwear

Naturalizer

Life Stride

Naturalsport

Dr. Scholl's

Disney

Buster Brown

Barbie

