TANDY LEATHER FACTORY INC
Form 10-Q
November 13, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012

or

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _________ to __________

Commission File Number 1-12368

TANDY LEATHER FACTORY, INC.
(Exact name of registrant as specified in its charter)

Delaware	75-2543540
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

1900 Southeast Loop 820, Fort Worth, Texas 76140
(Address of Principal Executive Offices) (Zip Code)

(817) 872-3200
(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such a shorter period that the registrant was required to submit and post such files). Yes [X] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [X] Smaller reporting company [ ]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X]

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Shares outstanding as of November 12, 2012
Common Stock, par value $0.0024 per share	10,158,442

TANDY LEATHER FACTORY, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2012

TABLE OF CONTENTS

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

Tandy Leather Factory, Inc.
Consolidated Balance Sheets

	September 30, 2012 (unaudited)	December 31, 2011 (audited)
ASSETS		
CURRENT ASSETS:		
Cash	$3,520,757	$10,765,591
Short-term investments, including certificates of deposit	-	423,893
Accounts receivable-trade, net of allowance for doubtful accounts of $213,000 and $81,000 in 2012 and 2011, respectively	1,074,877	1,328,579
Inventory	29,694,804	19,940,251
Prepaid income taxes	544,919	-
Deferred income taxes	427,360	281,251
Other current assets	1,089,675	948,459
Total current assets	36,352,392	33,688,024
PROPERTY AND EQUIPMENT, at cost	16,228,629	14,999,826
Less accumulated depreciation and amortization	(5,411,982)	(4,700,476)
	10,816,647	10,299,350
GOODWILL	992,027	987,009
OTHER INTANGIBLES, net of accumulated amortization of $574,000 and $539,000 in 2012 and 2011, respectively	154,059	187,292
Other assets	337,991	341,240
	$48,653,116	$45,502,915
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable-trade	$2,552,544	$1,622,697
Accrued expenses and other liabilities	5,738,356	4,641,191
Income taxes payable	-	638,897
Line of credit note	1,000,000	-
Current maturities of notes payable and long-term debt	202,500	202,500
Total current liabilities	9,493,400	7,105,285
DEFERRED INCOME TAXES	824,701	858,829
LONG-TERM DEBT, net of current maturities	2,953,125	3,105,000
COMMITMENTS AND CONTINGENCIES		

STOCKHOLDERS' EQUITY:		
Preferred stock, $0.10 par value; 20,000,000 shares authorized;		
none issued or outstanding; attributes to be determined on issuance	-	-
Common stock, $0.0024 par value; 25,000,000 shares authorized;		
11,152,065 and 11,150,065 shares issued at 2012 and 2011, respectively		
10,158,442 and 10,156,442 shares outstanding at 2012 and 2011, respectively	26,765	26,760
Paid-in capital	5,751,978	5,736,543
Retained earnings	32,040,319	31,181,936
Treasury stock at cost (993,623 shares at 2012 and 2011)	(2,894,068)	(2,894,068)
Accumulated other comprehensive income	456,896	382,630
Total stockholders' equity	35,381,890	34,433,801
	$48,653,116	$45,502,915

The accompanying notes are an integral part of these financial statements.

Table of Contents

Tandy Leather Factory, Inc.
Consolidated Statements of Income
(Unaudited)
For the Three and Nine Months Ended September 30, 2012 and 2011

	THREE MONTHS		NINE MONTHS	
	2012	2011	2012	2011
NET SALES	$17,000,728	$15,385,421	$52,082,061	$47,198,382
COST OF SALES	6,595,958	6,147,143	19,371,456	18,590,002
Gross profit	10,404,770	9,238,278	32,710,605	28,608,380
OPERATING EXPENSES	9,759,914	8,016,441	27,046,801	23,704,740
INCOME FROM OPERATIONS	644,856	1,221,837	5,663,804	4,903,640
OTHER INCOME (EXPENSE):				
Interest expense	(59,623)	(61,550)	(176,251)	(185,685)
Other, net	(2,787)	176,374	59,786	81,775
Total other income (expense)	(62,410)	114,824	(116,465)	(103,910)
INCOME FROM CONTINUING OPERATINGS BEFORE INCOME TAXES	582,446	1,336,661	5,547,339	4,799,730
PROVISION FOR INCOME TAXES	301,676	506,187	2,152,825	1,742,324
NET INCOME FROM CONTINUING OPERATIONS	280,770	830,474	3,394,514	3,057,406
INCOME FROM DISCONTINUED OPERATIONS, NET OF TAX	-	(1,368)	-	(1,368)
NET INCOME	$280,770	$829,106	$3,394,514	$3,056,038
NET INCOME FROM CONTINUING OPERATIONS PER COMMON SHARE:				
Basic	$0.03	$0.08	$0.33	$0.30
Diluted	$0.03	$0.08	$0.33	$0.30
NET INCOME FROM DISCONTINUED OPERATIONS PER COMMON SHARE:				

Basic	$0.00	$0.00	$0.00	$0.00
Diluted	$0.00	$0.00	$0.00	$0.00
NET INCOME PER COMMON SHARE:				
Basic	$0.03	$0.08	$0.33	$0.30
Diluted	$0.03	$0.08	$0.33	$0.30
WEIGHTED-AVERAGE SHARES OUTSTANDING				
Basic	10,156,790	10,156,442	10,156,559	10,156,442
Diluted	10,177,466	10,168,326	10,179,569	10,179,523

The accompanying notes are an integral part of these financial statements.

Table of Contents

Tandy Leather Factory, Inc.
Consolidated Statements of Comprehensive Income
(Unaudited)
For the Nine Months Ended September 30, 2012 and 2011

	THREE MONTHS		NINE MONTHS	
	2012	2011	2012	2011
NET INCOME	$280,770	$829,106	$3,394,514	$3,056,038
Foreign currency translation adjustments	174,633	(326,809)	74,266	(199,376)
COMPREHENSIVE INCOME	$455,403	$502,297	$3,468,780	$2,856,662

The accompanying notes are an integral part of these financial statements.

Table of Contents

Tandy Leather Factory, Inc.
Consolidated Statements of Cash Flows
(Unaudited)
For the Nine Months Ended September 30, 2012 and 2011

	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$3,394,514	$3,056,038
Loss from discontinued operations	-	1,368
	3,394,514	3,057,406
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	794,122	759,279
Loss on disposal or abandonment of assets	16,977	81,579
Non-cash stock-based compensation	10,000	33,156
Deferred income taxes	(180,237)	273,161
Other	63,559	(178,795)
Net changes in assets and liabilities, net of effect of business acquisitions:		
Accounts receivable-trade, net	253,702	(285,590)
Inventory	(9,754,553)	(315,259)
Income taxes	(1,183,816)	(554,681)
Other current assets	(141,216)	(394,666)
Accounts payable-trade	929,847	597,099
Accrued expenses and other liabilities	1,097,165	(1,467,520)
Total adjustments	(8,094,450)	(1,452,237)
Net cash (used in) provided by continuing operating activities	(4,699,936)	1,605,169
Cash used in discontinued operating activities	-	(1,067)
Net cash (used in) provided by operating activities	(4,699,936)	1,604,102
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(1,294,050)	(1,042,775)
Proceeds from maturities of certificates of deposit	423,893	1,285,593
Proceeds from sale of assets	1,150	25,473
Decrease (increase) in other assets	6,675	(22,636)
Net cash (used in) provided by investing activities	(862,332)	245,655
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net borrowings from line of credit	1,000,000	-
Payments on notes payable and long-term debt	(151,875)	(151,875)
Proceeds from issuance of common stock	5,440	-
Payment of cash dividend	(2,536,131)	-
Net cash used in financing activities	(1,682,566)	(151,875)
NET CHANGE IN CASH	(7,244,834)	1,697,882

CASH, beginning of period	10,765,591	4,293,746
CASH, end of period	$3,520,757	$5,991,628
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Interest paid during the period	$176,251	$185,685
Income tax paid during the period, net of (refunds)	$3,524,962	$1,940,659

The accompanying notes are an integral part of these financial statements.

Table of Contents

Tandy Leather Factory, Inc.
Consolidated Statements of Stockholders' Equity
Unaudited
For the Nine Months Ended September 30, 2012 and 2011

	Number of Shares	Par Value	Paid-in Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
BALANCE, December 31, 2010	10,156,422	$26,760	$5,703,387	$(2,894,068)	$26,429,335	$496,180	$29,761,594
Stock-based compensation	-	-	33,156	-	-	-	33,156
Net income	-	-	-	-	3,056,038	-	3,056,038
Translation adjustment	-	-	-	-	-	(199,376)	(199,376)
BALANCE, September 30, 2011	10,156,422	$26,760	$5,736,543	$(2,894,068)	$29,485,373	$296,804	$32,651,412

	Number of Shares	Par Value	Paid-in Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
BALANCE, December 31, 2011	10,156,442	$26,760	$5,736,543	$(2,894,068)	$31,181,936	$382,630	$34,433,801
Shares issued – stock options exercised	2,000	5	5,435	-	-	-	5,440
Stock-based compensation	-	-	10,000	-	-	-	10,000
Cash dividend	-	-	-	-	(2,536,131)	-	(2,536,131)
Net income	-	-	-	-	3,394,514	-	3,394,514
Translation adjustment	-	-	-	-	-	74,266	74,266
BALANCE, September 30, 2012	10,158,442	$26,765	$5,751,978	$(2,894,068)	$32,040,319	$456,896	$35,381,890

The accompanying notes are an integral part of these financial statements.

Table of Contents

TANDY LEATHER FACTORY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION AND CERTAIN SIGNIFICANT ACCOUNTING POLICIES

In the opinion of management, the accompanying consolidated financial statements for Tandy Leather Factory, Inc. and its consolidated subsidiaries contain all adjustments (consisting of normal recurring adjustments and the accrual of the settlement described in Note 7) necessary to present fairly its financial position as of September 30, 2012 and December 31, 2011, and its results of operations and cash flows for the three and/or nine-month periods ended September 30, 2012 and 2011. Operating results for the three and nine-month periods ended September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended December 31, 2011.

The preparation of financial statements in accordance with accounting principles generally accepted in the United States 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.

Inventory. Inventory is stated at the lower of cost or market and is accounted for on the “first in, first out” method. Based on negotiations with vendors, title generally passes to us when merchandise is put on board. Merchandise to which we have title but which have not yet received is recorded as inventory in transit. In addition, the value of inventory is periodically reduced for slow-moving or obsolete inventory based on management's review of items on hand compared to their estimated future demand.

The components of inventory consist of the following:

	As of	
	September 30, 2012	December 31, 2011
Inventory on hand:		
Finished goods held for sale	$28,132,380	$17,742,298
Raw materials and work in process	805,124	479,686
Inventory in transit	757,300	1,718,267
	$29,694,804	$19,940,251

Goodwill and Other Intangibles. Goodwill represents the excess of the purchase price over the fair value of net assets acquired in a business combination. Goodwill is required to be evaluated for impairment on an annual basis, absent indicators of impairment during the interim. Application of the goodwill impairment test requires exercise of judgment, including the estimation of future cash flows, determination of appropriate discount rates and other important assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value and/or goodwill impairment for each reporting unit.

A two-step process is used to test for goodwill impairment. The first phase screens for impairment, while the second phase (if necessary) measures the impairment. We have elected to perform the annual analysis during the fourth calendar quarter of each year. As of December 31, 2011, management determined that the present value of the discounted estimated future cash flows of the stores associated with the goodwill is sufficient to support their respective goodwill balances. No indicators of impairment were identified during the first three quarters of 2012.

In accordance with recent guidance from the FASB, beginning in 2012, we are permitted to first assess qualitative factors in testing goodwill for impairment prior to performing a quantitative assessment.

A summary of changes in our goodwill for the periods ended September 30, 2012 and 2011 is as follows:

	Leather Factory	Tandy Leather	Total
Balance, December 31, 2010	$606,962	$383,406	$990,368
Acquisitions and adjustments	-	-	-
Foreign exchange gain/loss	(6,024)	-	(6,024)
Impairments	-	-	-
Balance, September 30, 2011	$600,938	$383,406	$984,344

	Leather Factory	Tandy Leather	Total
Balance, December 31, 2011	$603,603	$383,406	$987,009
Acquisitions and adjustments	-	-	-
Foreign exchange gain/loss	5,018	-	5,018
Impairments	-	-	-
Balance, September 30, 2012	$608,621	$383,406	$992,027

Other intangibles consist of the following:

	As of September 30, 2012			As of December 31, 2011		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
Trademarks, Copyrights	$544,369	$449,060	$95,309	$544,369	$425,418	$118,951
Non-Compete Agreements	183,514	124,764	58,750	182,365	114,024	68,341
	$727,883	$573,824	$154,059	$726,734	$539,442	$187,292

We recorded amortization expense of $33,378 during the first nine months of 2012 compared to $33,401 during the first nine months of 2011. All of our intangible assets are subject to amortization under U.S. GAAP. Based on the current amount of intangible assets subject to amortization, the estimated amortization expense for each of the succeeding 5 years is as follows:

	Wholesale Leathercraft	Retail Leathercraft	Total
2012	$1,477	$37,634	$39,111
2013	-	33,337	33,337
2014	-	33,337	33,337
2015	-	28,636	28,636
2016	-	2,000	2,000

Revenue Recognition. Our sales generally occur via two methods: (1) at the counter in our stores, and (2) shipment by common carrier. Sales at the counter are recorded and title passes as transactions occur. Otherwise, sales are recorded and title passes when the merchandise is shipped to the customer. Our shipping terms are FOB shipping point.

We offer an unconditional satisfaction guarantee to our customers and accept all product returns. Net sales represent gross sales less negotiated price allowances, product returns, and allowances for defective merchandise.

Table of Contents

Comprehensive Income (loss) and Accumulated Other Comprehensive Income (loss). Comprehensive income (loss) is defined as the change in equity during a period from transactions and other events and circumstances from non-stockholder sources and includes all changes in equity during a period except those resulting from investments by and dividends to stockholders. Our comprehensive income (loss) consists of our net income and foreign currency translation adjustments from our international operations.

Recent Accounting Pronouncements. In June 2011, FASB issued ASU 2011-05, "Comprehensive Income (Topic 220) – Presentation of Comprehensive Income" (ASU 2011-05). This standard update requires an entity to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of stockholders' equity. ASU 2011-05 is effective for the interim and annual periods beginning after December 15, 2011. The adoption of the standard did not have a material impact on our consolidated financial statements.

In September 2011, FASB issued ASU 2011-08, "Intangibles-Goodwill and Other (Topic 350) – Testing Goodwill for Impairment". ASU 2011-08 provides companies with a new option to determine whether or not it is necessary to apply the traditional two-step quantitative goodwill impairment test in ASC 350, Intangibles – Goodwill and Other. Under ASU 2011-08 companies are no longer required to calculate the fair value of a reporting unit unless it determines, on the basis of qualitative information, that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. ASU 2011-08 is effective for periods ending after December 15, 2011. The adoption of the standard did not have a material impact on our consolidated financial statements.

2. SHORT-TERM INVESTMENTS

All current fixed maturity securities are classified as "available for sale" and are reported at carrying value, which approximates fair value based on the discounted value of contractual cash flows. We have determined that our investment securities are available to support current operations and, accordingly, have classified such securities as current assets without regard to contractual maturities. Investments at December 31, 2011 consisted of certificates of deposit. No certificates of deposit or other short-term investments were held as of September 30, 2012.

3. NOTES PAYABLE AND LONG-TERM DEBT

On July 31, 2007, we entered into a Credit Agreement and Line of Credit Note with JPMorgan Chase Bank, N.A., pursuant to which the bank agreed to provide us with a credit facility of up to $5,500,000 to facilitate our purchase of real estate consisting of a 191,000 square foot building situated on 30 acres of land located at 1900 SE Loop 820 in Fort Worth, Texas. Proceeds in the amount of $4,050,000 were used to fund the purchase of the property. On April 30, 2008, the principal balance was rolled into a 10-year term note with a 20-year amortization that accrues interest at a rate of 7.10% per annum.

At September 30, 2012 and December 31, 2011, the amount outstanding under the above agreement consisted of the following:

	September 30, 2012	December 31, 2011
Credit Agreement with JPMorgan Chase Bank – collateralized by real estate; payable as follows:		
Line of Credit Note dated July 31, 2007, converted to a 10-year term note on April 30, 2008; $16,875 monthly principal payments plus interest at 7.1% per annum;	$ 3,155,625	$3,307,500

matures April 30, 2018		
Less - Current maturities	(202,500)	(202,500)
	$2,953,125	$3,105,000

On July 12, 2012, we executed a Line of Credit Note with JPMorgan Chase Bank, N.A., pursuant to which the bank agreed to provide us with a revolving credit facility of up to $4,000,000. The revolver bears interest at LIBOR plus 2.0% (2.2185% at September 30, 2012) and matures on June 30, 2013. Interest is paid monthly. This note was obtained for working capital purposes.

4. STOCK-BASED COMPENSATION

We have one stock option plan which provides for annual stock option grants to non-employee directors with an exercise price equal to the fair market value of the shares at the date of grant. Under this plan, 12,000 options were awarded to directors in each of the first nine months of 2012 and 2011. These options vest and become exercisable six months from the option grant date. We had two other stock option plans from 1995 which provided for stock option grants to officers, key employees and non-employee directors. These plans expired in 2005. The expiration of the plans has no effect on the options previously granted. Options outstanding and exercisable were granted at a stock option price which was not less than the fair market value of our common stock as of closing on the date the option was granted and no option has a term in excess of ten years. We recognized share based compensation expense of $0 and $7,126 for each of the quarters ended September 30, 2012 and 2011, respectively, and $10,000 and $33,156 for each of the nine month periods ended September 30, 2012 and 2011, respectively, as a component of operating expenses.

During the nine months ended September 30, 2012 and 2011, the stock option activity under our stock option plans was as follows:

	Weighted Average Exercise Price	# of shares	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding, January 1, 2011	$4.35	103,600		
Granted	4.80	12,000		
Cancelled	-	-		
Exercised	-	-		
Outstanding, September 30, 2011	$4.40	115,600	5.40	$206,332
Exercisable, September 30, 2011	$4.40	115,600	5.40	$206,332
Outstanding, January 1, 2012	$4.40	115,600		
Granted	5.27	12,000		
Cancelled	-	-		
Exercised	2.72	(2,000)		
Outstanding, September 30, 2012	$4.51	125,600	4.93	$213,256
Exercisable, September 30, 2012	$4.51	125,600	4.93	$213,256

Other information pertaining to option activity during the nine-month periods ended September 30, 2012 and 2011 are as follows:

	September 30, 2012	September 30, 2011
Weighted average grant-date fair value of stock options granted	$0.83	$1.19
Total fair value of stock options vested	$10,000	$52,057
Total intrinsic value of stock options exercised	$3,077	N/A

As of September 30, 2012 and 2011, there was no unrecognized compensation cost related to non-vested stock options.

Table of Contents

5. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share ("EPS") for the three and nine months ended September 30, 2012 and 2011:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Numerator:				
Net income	$280,770	$829,106	$3,394,514	$3,056,038
Numerator for basic and diluted earnings per share	280,770	829,106	3,394,514	3,056,038
Denominator:				
Weighted-average shares outstanding-basic	10,156,790	10,156,442	10,156,559	10,156,442
Effect of dilutive securities:				
Stock options	20,676	11,884	23,010	23,081
Dilutive potential common shares	20,676	11,884	23,010	23,081
Denominator for diluted earnings per share-weighted-average shares	10,177,466	10,168,326	10,179,569	10,179,523
Basic earnings per share	$0.03	$0.08	$0.33	$0.30
Diluted earnings per share	$0.03	$0.08	$0.33	$0.30

The net effect of converting stock options to purchase 127,600 and 102,600 shares of common stock at exercise prices less than the average market prices has been included in the computations of diluted earnings per share for the quarter ended September 30, 2012 and 2011, respectively.

6. CASH DIVIDEND

In February 2012, our Board of Directors authorized a $0.25 per share special one-time cash dividend that was paid to stockholders of record at the close of business on March 1, 2012. We released the funds used to pay for the special one-time cash dividend on March 29, 2012 and the dividend, totaling $2.5 million, was paid to stockholders on April 2, 2012. Our Board will determine future cash dividends after giving consideration to our then existing levels of profit and cash flow, capital requirements, current and forecasted liquidity, as well as financial and other business conditions existing at the time.

7. COMMITMENTS AND CONTINGENCIES

Legal Proceedings. On March 16, 2011, two former employees of ours filed a lawsuit, entitled Mark Barnes and Jerry Mercante on behalf of themselves and all other similarly situated v. Tandy Leather Company, Inc., Tandy Leather Factory, and Does 1-50, in the US District Court for the District of Nevada. The lawsuit was subsequently amended on May 9, 2011 to add another former employee, Donna Cavota, as a third named plaintiff. The suit alleges that we violated requirements of the Fair Labor Standards Act (FLSA) as well as various state wage laws. Plaintiffs seek to represent themselves and all similarly situated U.S. current and former store managers of ours. Plaintiffs seek reimbursement for an unspecified amount of unpaid overtime compensation, liquidated damages, attorneys' fees and costs. On May 17, 2011, the district court in Nevada granted our request to transfer venue to the Northern District of Texas.

On September 24, 2012, an agreement was reached and preliminarily approved by the United States District Court, Northern District of Texas, Fort Worth Division, to settle all federal and state claims asserted by the plaintiffs (the "Settlement Agreement"). At all times during the pendency of this litigation, we have vigorously denied all of the plaintiffs' allegations. As part of the settlement, we continue to deny any violation of any statute, law, rule or regulation, any liability or wrongdoing, and the truth of all of the plaintiffs' allegations. We have agreed to enter into the Settlement Agreement to avoid further expense and inconvenience, end the disruption and burden of the litigation, avoid any other present or future litigation arising out of the facts that gave rise to the litigation, avoid the risk inherent in uncertain complex litigation, and put to rest the controversy underlying the litigation.

The Settlement Agreement required us to establish a $993,385.90 escrow account to fund (1) settlement payments to the plaintiffs, (2) settlement payments to the other members of the settlement class who join the class action, (3) attorneys' fees and expenses, and (4) escrow agent fees and expenses. The plaintiffs and each other member of the settlement class who joins the class action release any and all claims against us related to the conduct alleged by the plaintiffs in the class action suit. The Settlement Agreement includes a formula to determine the amount of settlement payments payable to each claimant. If the aggregate amount of settlement payments determined by such formula exceeds the remaining balance in the escrow fund, we will have no further liability. Instead, the amount of settlement payments payable to the claimants will be reduced proportionately. To the extent that any funds remain in the escrow fund after payment of all required claims, fees and expenses, the remaining funds will be returned to us. The foregoing description is not complete and is qualified in its entirety by reference to the full text of the Settlement Agreement which was attached as Exhibit 10.1 to a Form 8-K Current Report on Form 8-K, as filed with the Securities and Exchange Commission on September 28, 2012.

The Settlement Agreement remains subject to a fairness hearing and final approval by the Court. A Fairness Hearing will be held in the Fourth Floor Courtroom of the United States Courthouse, Fort Worth, Texas, at 10:00 o'clock a.m. on February 11, 2013, to make final determinations as to whether the settlement described in the Settlement Agreement is fair, reasonable and adequate, whether it should be finally approved by the Court, and whether an Order and Final Judgment should be issued dismissing the lawsuit with prejudice.

In connection with the settlement, we recorded a charge to operations of $993,385.90 during the quarter ended September 30, 2012.

We are periodically involved in other various litigation that arises in the ordinary course of business and operations. There are no such matters pending that we expect to have a material impact on our financial position and operating results. Legal costs associated with the resolution of claims, lawsuits and other contingencies are expensed as incurred.

8. SEGMENT INFORMATION

We identify our segments based on the activities of three distinct operations:

a. Wholesale Leathercraft, which consists of a chain of wholesale stores operating under the name, The Leather Factory, located in North America;

b. Retail Leathercraft, which consists of a chain of retail stores operating under the name, Tandy Leather Company, located in the North America; and

c. International Leathercraft, which sells to both wholesale and retail customers. We have three stores operating in this segment: one in Northampton, United Kingdom which opened in February 2008, one in Sydney, Australia which opened in October 2011, and one in Jerez, Spain, which opened in January 2012. These stores carry the same products as our North American stores.

Our reportable operating segments have been determined as separately identifiable business units, and we measure segment earnings as operating earnings, defined as income before interest and income taxes.

Table of Contents

	Wholesale Leathercraft	Retail Leathercraft	Int'l Leathercraft	Total
For the quarter ended September 30, 2012				
Net sales	$6,242,602	$9,947,911	$810,215	$17,000,728
Gross profit	4,111,067	5,848,397	445,306	10,404,770
Operating earnings	(297,897)	987,704	(44,951)	644,856
Interest (expense)	(59,623)	-	-	(59,623)
Other income (expense), net	15,926	-	(18,713)	(2,787)
Income before income taxes	(341,594)	987,704	(63,664)	582,446
Depreciation and amortization	205,991	50,650	13,428	270,069
Fixed asset additions	779,676	107,234	3,529	908,210
Total assets	$35,690,494	$10,719,659	$2,242,963	$48,653,116
For the quarter ended September 30, 2011				
Net sales	$6,150,138	$8,744,446	$490,837	$15,385,421
Gross profit	3,733,345	5,178,788	326,145	9,238,278
Operating earnings	296,824	811,347	113,666	1,221,837
Interest (expense)	(61,550)	-	-	(61,550)
Other income (expense), net	175,715	(1,577)	2,236	176,374
Income before income taxes	410,989	809,770	115,902	1,336,661
Depreciation and amortization	216,958	42,836	2,134	261,928
Fixed asset additions	239,477	114,200	191,613	545,290
Total assets	$32,903,869	$7,225,267	$2,043,348	$42,172,484

	Wholesale Leathercraft	Retail Leathercraft	Int'l Leathercraft	Total
For the nine months ended September 30, 2012				
Net sales	$19,678,009	$30,093,864	$2,310,188	$52,082,061
Gross profit	12,914,740	18,365,729	1,430,136	32,710,605
Operating earnings	2,038,267	3,655,932	(30,395)	5,663,804
Interest (expense)	(176,251)	-	-	(176,251)
Other income (expense), net	44,275	13	15,498	59,786
Income before income taxes	1,906,291	3,655,945	(14,897)	5,547,339
Depreciation and amortization	613,608	140,566	39,948	794,122
Fixed asset additions	913,900	303,525	76,625	1,294,050
Total assets	$35,690,494	$10,719,659	$2,242,963	$48,653,116
For the nine months ended September 30, 2011				
Net sales	$19,341,919	$26,327,904	$1,528,559	$47,198,382
Gross profit	11,781,622	15,829,914	996,844	28,608,380
Operating earnings	1,709,226	2,857,986	336,428	4,903,640
Interest expense	(185,685)	-	-	(185,685)
Other income (expense), net	69,968	(7,613)	19,420	81,775
Income before income taxes	1,593,509	2,850,373	355,848	4,799,730

Depreciation and amortization	636,050	115,597	7,632	759,279
Fixed asset additions	520,805	328,857	193,113	1,042,775
Total assets	$32,903,869	$7,225,267	$2,043,348	$42,172,484

Net sales for geographic areas were as follows for the three and nine months ended September 30, 2012 and 2011:

Three months ended September 30,	2012	2011
United States	$14,221,642	$13,078,107
Canada	1,761,960	1,560,808
All other countries	1,017,126	746,506
	$17,000,728	$15,385,421

Nine months ended September 30,	2012	2011
United States	$43,861,288	$40,056,351
Canada	5,214,782	4,832,078
All other countries	3,005,991	2,309,953
	$52,082,061	$47,198,382

Geographic sales information is based on the location of the customer. No single foreign country, except for Canada, accounted for any material amount of our consolidated net sales for the three or nine-month periods ended September 30, 2012 and 2011. We do not have any significant long-lived assets outside of the United States.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Our Business

We are one of the world's largest specialty retailers and wholesale distributor of leather and leathercraft related items. We market our products to our growing list of customers through company-owned retail and wholesale stores. We are a Delaware corporation, and our common stock trades on the NASDAQ Global Market under the symbol "TLF." We operate our business in three segments: Wholesale Leathercraft, which operates wholesale stores in North America under the trade name, The Leather Factory, Retail Leathercraft, which operates retail stores in North America under the trade name, Tandy Leather Company, and International Leathercraft, which operates combination retail/wholesale stores outside of North America under the trade name, Tandy Leather Factory. See Note 8 to the consolidated financial statements included in Item 1 of this Report for additional information concerning our segments, as well as our foreign operations.

Our Wholesale Leathercraft segment operates 29 company-owned wholesale stores in 19 states and three Canadian provinces. These stores are engaged in the wholesale distribution of leather and related items, including leatherworking tools, buckles and belt adornments, leather dyes and finishes, saddle and tack hardware, and do-it-yourself kits to retailers, manufacturers, and end users. Our Wholesale Leathercraft segment also includes our National Account sales group, whose customers are only national craft chains.

Table of Contents

Our Retail Leathercraft segment operates company-owned Tandy Leather Company retail stores in 36 states and six Canadian provinces. Tandy Leather Company, one of the oldest and best-known suppliers of leather and related supplies used in the leathercraft industry, has been a primary leathercraft resource for decades. Tandy Leather Company's products include quality tools, leather, accessories, kits and teaching materials. In 2002, we began expanding Tandy Leather Company's industry presence by opening retail stores. As of November 1, 2012, we were operating 77 Tandy Leather Company retail stores located throughout the United States and Canada.

Our International Leathercraft segment operates 3 company-owned stores, all located outside of North America. These stores operate as combination retail / wholesale stores and consist of one store in Northampton, United Kingdom, one store in Sydney, Australia, and one store in Jerez, Spain. We expect to open additional stores outside of North America in the future, although specific locations and opening dates have not yet been determined.

Critical Accounting Policies

A description of our critical accounting policies appears in Item 7 "Management's Discussions and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

Forward-Looking Statements

Certain statements contained in this report and other materials we file with the Securities and Exchange Commission, as well as information included in oral statements or other written statements made or to be made by us, other than statements of historical fact, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements generally are accompanied by words such as "may," "will," "could," "should," "anticipate," "believe," "budgeted," "intend," "plan," "project," "potential," "estimate," "continue," or "future" variations thereof or other similar statements. Th certain important risks that could cause results to differ materially from those anticipated by some of the forward-looking statements. Some, but not all, of the important risks, including those described below, could cause actual results to differ materially from those suggested by the forward-looking statements. Please refer also to our Annual Report on Form 10-K for fiscal year ended December 31, 2011 for additional information concerning these and other uncertainties that could negatively impact the Company.

Ø Our business may be negatively impacted by general economic conditions and the current global financial crisis.

Our performance is subject to worldwide economic conditions and their impact on levels of consumer spending that affect not only the ultimate consumer, but also small businesses and other retailers. The United States and global economies have suffered from a prolonged recession for the past several years and as a result, consumer spending has remained depressed, and may be subject to further deterioration for the foreseeable future. Specialty retail, and retail in general, are heavily influenced by general economic cycles. Purchases of non-essential products tend to decline in periods of recession or uncertainty regarding future economic prospects, as disposable income declines. During periods of economic uncertainty, we may not be able to maintain or increase our sales to existing customers, make sales to new customers, open and operate new stores, maintain sales levels at our existing stores, maintain or increase our international operations on a profitable basis, or maintain our earnings from operations as a percentage of net sales. As a result, our operating results may be adversely and materially affected by continued downward trends or uncertainty in the United States or global economies.

Ø Our profitability may decline as a result of increasing pressure on margins.

Our industry is subject to significant pricing pressure caused by many factors, including fluctuations in the cost of the leather and metal products that we purchase and changes in consumer spending patterns and acceptance of our products. These factors may prohibit us from passing cost increases on to customers which could cause our gross margin to decline. If our product costs increase and our sale prices do not, our future operating results could be adversely affected unless we are able to offset such gross margin declines with comparable reductions in operating costs.

Ø We may be unsuccessful in implementing our planned international expansion, which could impair the value of our brand, harm our business and negatively affect our results of operation.

We plan to grow our net sales and net earnings from our International segment by opening stores in various international markets. As we expand outside of North America, we may incur significant costs relating to starting up, maintaining and expanding foreign operations. Costs may include, but are not limited to, obtaining locations for stores, hiring personnel, and travel expenses. We may be unable to open and operate new stores successfully and our growth may be limited, unless we are able to identify desirable sites for store locations; negotiate acceptable lease terms; hire, train and retain competent store personnel; manage inventory effectively to meet the needs and demands of customers on a timely basis; manage foreign currency risk effectively; and achieve acceptable operating margins from the new stores. We cannot be sure that we can successfully open new stores or that our new stores will be profitable.

As we continue to increase our international operations, we face the possibility of greater losses from a number of risks inherent in doing business in international markets and from a number of factors which are beyond our control, such as political instability or acts of terrorism, which disrupt trade with the countries in which our suppliers or customers are located; local business practices that do not conform to legal or ethical guidelines; restrictions or regulations relating to imports or exports; additional or increased customs duties, tariffs, taxes and other charges on imports; significant fluctuations in the value of the dollar against foreign currencies; social, legal or economic instability in the foreign markets in which we do business, which could influence our ability to sell our products in these markets; and restrictions on the transfer of funds between the United States and foreign jurisdictions.

We assume no obligation to update or otherwise revise our forward-looking statements even if experience or future changes make it clear that any projected results, express or implied, will not be realized.

Results of Operations

Three Months Ended September 30, 2012 and 2011

The following tables present selected financial data of each of our three segments for the quarters ended September 30, 2012 and 2011.

	Quarter Ended September 30, 2012		Quarter Ended September 30, 2011	
	Sales	Operating Income (Loss)	Sales	Operating Income
Wholesale Leathercraft	$6,242,602	$(297,897)	$6,150,138	$296,824
Retail Leathercraft	9,947,911	987,704	8,744,446	811,347
Int’l Leathercraft	810,215	(44,951)	490,837	113,666
Total Operations	$17,000,728	$644,856	$15,385,421	$1,221,837

Consolidated net sales for the quarter ended September 30, 2012 increased $1.6 million, or 10.5%, compared to the same period in 2011. All three segments contributed to the sales increase. Operating income on a consolidated basis for the quarter ended September 30, 2012 was down 47.2%, or $577,000, from the third quarter of 2011. The settlement of the litigation described in Note 7 to the consolidated financial statements included in Item 1 of this Report accounted for the decrease in operating income. The expense was recorded in our Wholesale Leathercraft segment. Our Retail Leathercraft segment reported an increase in operating income of 21.7%, offset by operating losses of 200% and 140% in our Wholesale and International Leathercraft segments, respectively.

The following table shows in comparative form our consolidated net income for the third quarters of 2012 and 2011:

	2012	2011	% change
Net income	$280,770	$829,106	(66.2)%

Additional information appears below for each segment.

Table of Contents

Wholesale Leathercraft

Our Wholesale Leathercraft segment consists of 29 wholesale stores and our National Account sales group. The National Account sales group’s customers consist of only national craft chains. The following table presents the combined sales mix by customer categories for the quarters ended September 30, 2012 and 2011:

	Quarter Ended	
Customer Group	09/30/12	09/30/11
RETAIL (end users, consumers, individuals)	33%	28%
INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.)	6%	5%
WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.)	44%	44%
MANUFACTURERS	8%	7%
NATIONAL ACCOUNTS	9%	16%
	100%	100%

Net sales increased 1.5%, or $92,000, for the third quarter of 2012 as follows:

	# Stores	Qtr Ended 09/30/12	Qtr Ended 09/30/11	$ Change	% Change
Same store sales	29	$5,821,208	$5,361,239	$459,969	8.6%
National account group		421,394	788,899	(367,505)	(46.6)%
Total sales		$6,242,602	$6,150,138	$92,464	1.5%

Our same store sales increased 8.6% in the third quarter of 2012, as compared with the same period in 2011. Compared to the third quarter of 2011, we achieved sales dollar increases in all customer categories, with the exception of our National Account group. Sales to our National Account customers were down 47% for the quarter, compared to the same quarter last year. Our sales to these customers are dependent on what products we are willing to develop specifically for this group and the level of inventory we are willing to house in anticipation of orders. We have intentionally eliminated some products from our line because the gross profit margins were lower than we were willing to accept. Therefore, it is likely we will experience further sales declines to our National Account group if the product we stock is not what these customers want to purchase. Our primary focus is on sales through our stores, rather than National Accounts, as we believe our stores represent the greatest potential for continued and consistent sales growth.

Operating income for Wholesale Leathercraft during the quarter ended September 30, 2012 decreased by $595,000 from the comparative 2011 quarter, a decrease of 200%. Operating expenses as a percentage of sales were 70.6%, up $972,000 from the third quarter of 2011. The primary reason for the operating expense increase was the one-time charge of $994,000 related to the settlement of litigation. (See Note 7 to the consolidated financial statements included in Item 1 of this Report for additional information.) Other changes in operating expenses consisted of a decrease in legal fees of $100,000, an increase in employee compensation of $100,000, and a reduction in employee benefits, namely our employee health care program, of $150,000. Excluding the one-time settlement expense, operating expenses as a percentage of sales was 54.7%, down $21,000 from the third quarter of 2011.

Retail Leathercraft

Our Retail Leathercraft segment consists of 77 Tandy Leather Company retail stores at September 30, 2012 and 2011. Net sales increased 13.8% for the third quarter of 2012 over the same quarter last year. A store is categorized as “new” until it is operating for the full comparable period in the prior year.

	# Stores	Qtr Ended 09/30/12	Qtr Ended 09/30/11	$ Change	% Change
Same store sales	77	$9,947,911	$8,744,446	$1,203,465	13.8%
New store sales	-	-	-	-	-
Total sales		$9,947,911	$8,744,446	$1,203,465	13.8%

The following table presents sales mix by customer categories for the quarters ended September 30, 2012 and 2011 for our Retail Leathercraft operation:

	Quarter Ended	
Customer Group	09/30/12	09/30/11
RETAIL (end users, consumers, individuals)	60%	59%
INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.)	5%	5%
WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.)	33%	33%
NATIONAL ACCOUNTS	-	-
MANUFACTURERS	2%	3%
	100%	100%

The retail stores averaged approximately $43,000 in sales per month for the third quarter of 2012.

Sales to each customer group increased solidly over the third quarter of 2011, with the exception of our Manufacturer customer group. Operating income increased $176,000, or 21.7%, from the comparative 2011 quarter. Operating income as a percentage of sales also increased from 9.3% in the third quarter of 2011 to 9.9% in the third quarter of 2012. Gross profit margin declined slightly from 59.2% to 58.8%. Operating expenses as a percentage of sales decreased from 50.0% to 48.9% as expenses grew at a slower rate than that of sales during the quarter. Operating expenses increased $493,000 over the third quarter of 2011, with increases in employee compensation and benefits of $175,000, advertising and marketing expenses of $90,000, travel expense associated with store relocations of $30,000, and rent and utilities expense of $85,000 accounting for the majority of the increase.

International Leathercraft

International Leathercraft consists of all stores located outside of North America. As of September 30, 2012, the segment contained three stores with one store located in United Kingdom, one store located in Australia, and one store located in Spain. As of September 30, 2011, the segment consisted of the one store located in the United Kingdom. Net sales increased 65.1% for the third quarter of 2012 over the same quarter last year as a result of the addition of new stores. A store is categorized as "new" until it is operating for the full comparable period in the prior year.

	# Stores	Qtr Ended 09/30/12	Qtr Ended 09/30/11	$ Change	% Change
Same store sales	1	$491,869	$490,837	$1,032	0.2%
New store sales	2	318,346	-	318,346	N/A
Total sales		$810,215	$490,837	$319,378	65.1%

Gross profit margin as a percentage of sales decreased from 66.5% in the third quarter of 2011 to 55.0% in the third quarter of 2012. The cost of goods is typically higher in these stores than that of the North American stores due to the higher freight costs incurred to get product to the stores. Further, we determine selling prices taking into consideration the currency conversion between the U.S. dollar and the local currency. Therefore, gross profit margin can fluctuate as a result of sales mix (the ratio of selling higher margin tools and supplies to lower margin leather), shipping methods (air versus ocean) when we ship merchandise to the stores, and the currency conversion rate we use to convert US dollar selling prices to local currency selling prices. Operating expenses totaled $490,000 in the third quarter of 2012, up from $212,000 in the third quarter of 2011, all attributable to the new stores' operations. Employee compensation is this division's largest expense, followed by advertising, shipping costs to customers, and rent.

Table of Contents

Other Expenses

We paid $60,000 in interest expense in the third quarter of 2012 on our debt compared to $62,000 in interest expense in the third quarter last year. Due to the reduction in cash on hand compared to last year, we earned $500 in interest income during the third quarter of 2012, down from last year's third quarter interest income earned of $15,000. We recorded expense of $18,000 during the third quarter of 2012 related to currency fluctuations from our international operations. Comparatively, in the third quarter of 2011, we recorded income of $145,000 for currency fluctuations.

Nine Months Ended September 30, 2012 and 2011

The following table presents selected financial data of each of our three segments for the nine months ended September 30, 2012 and 2011:

	Nine Months Ended September 30, 2012		Nine Months Ended September 30, 2011	
	Sales	Operating Income (Loss)	Sales	Operating Income
Wholesale Leathercraft	$19,678,009	$2,038,267	$19,341,919	$1,709,226
Retail Leathercraft	30,093,864	3,655,932	26,327,904	2,857,986
International Leathercraft	2,310,188	(30,395)	1,528,559	336,428
Total Operations	$52,082,061	$5,663,804	$47,198,382	$4,903,640

Consolidated net sales for the nine months ended September 30, 2012 were up 10% compared to the same period in 2011, increasing $4.9 million. All three reporting segments contributed to the sales increase. Retail Leathercraft contributed the largest sales increase of $3.8 million, followed by International Leathercraft reporting an increase of $781,000 and Wholesale Leathercraft reporting an increase of $336,000. Operating income on a consolidated basis for the nine months ended September 30, 2012 was up 15.5% compared to the first nine months of 2011, increasing $760,000.

The following table shows in comparative form our consolidated net income for the first three quarters of 2012 and 2011:

	2012	2011	% change
Net income	$3,394,514	$3,056,038	11.1%

Wholesale Leathercraft

Net sales increased 1.7%, or $336,000, for the first three quarters of 2012 as follows:

	# Stores	Nine Months Ended 09/30/12	Nine Months Ended 09/30/11	$ Change	% Change
Same store sales	29	$18,232,337	$17,133,069	$1,099,268	6.4%
National account group		1,445,672	2,208,850	(763,178)	(34.6)%
Total sales		$19,678,009	$19,341,919	$336,090	1.7%

The following table presents the combined sales mix by customer categories for the nine months ended September 30, 2012 and 2011:

	Nine Months Ended	
Customer Group	09/30/12	09/30/11
RETAIL (end users, consumers, individuals)	34%	31%
INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.)	5%	6%
WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.)	43%	44%
MANUFACTURERS	8%	7%
NATIONAL ACCOUNTS	10%	12%
	100%	100%

Operating income for Wholesale Leathercraft for the first three quarters of 2012 increased by $329,000 from the comparative 2011 period, an improvement of 19.3%. Compared to the first nine months of 2011, operating expenses increased $804,000 for the first nine months of 2012, increasing as a percentage of sales from 52.1% to 55.3%. The primary reason for the operating expense increase was the one-time charge in the third quarter of 2012 of $994,000 related to the settlement of litigation. (See Note 7 to the consolidated financial statements included in Item 1 of this Report for additional information.) Excluding the one-time settlement expense, 2012 year-to-date operating expenses as a percentage of sales were 50.2%, down $189,000 from the same period of 2011.

Retail Leathercraft
Net sales were up 14.3% for the first nine months of 2012 over the same period last year.

	# Stores	Nine Months Ended 09/30/12	Nine Months Ended 09/30/11	$ Change	% Change
Same (existing) store sales	76	$29,794,423	$26,252,161	$3,542,262	13.5%
New store sales	1	299,441	75,743	223,698	N/A
Total sales		$30,093,864	$26,327,904	$3,765,960	14.3%

The following table presents sales mix by customer categories for the nine months ended September 30, 2012 and 2011 for our Retail Leathercraft operation:

	Nine Months Ended	
Customer Group	09/30/12	09/30/11
RETAIL (end users, consumers, individuals)	59%	60%
INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.)	5%	6%
WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.)	33%	31%
NATIONAL ACCOUNTS	-	-
MANUFACTURERS	3%	3%
	100%	100%

The retail stores averaged approximately $43,000 in sales per month per store for the first nine months of 2012.

Operating income for the first nine months of 2012 increased $1.7 million from the comparative 2011 period, improving as a percentage of sales from 10.9% in the first three quarters of 2011 to 12.2% in the first three quarters of 2012. Gross margin increased slightly from 60.1% to 61.0%. Operating expenses as a percentage of sales were 48.9% in the first nine months of 2012 compared to 49.3% in the first nine months of 2012, as sales grew slightly faster than expenses.

12

Table of Contents

International Leathercraft

International Leathercraft consists of all stores located outside of North America. As of September 30, 2012, the segment contained three stores with one store located in United Kingdom, one store located in Australia, and one store located in Spain. As of September 30, 2011, the segment consisted of the one store located in the United Kingdom. Net sales increased 51.1% for the first three quarters of 2012 over the same period last year. A store is categorized as "new" until it is operating for the full comparable period in the prior year.

	# Stores	Nine Months Ended 09/30/12	Nine Months Ended 09/30/11	$ Change	% Change
Same store sales	1	$1,507,075	$1,528,559	$(21,484)	(1.4)
New store sales	2	803,113	-	803,113	N/A
Total sales		$2,310,188	$1,528,559	$781,629	51.1%

Gross profit margin as a percentage of sales decreased from 65.2% in the first nine months of 2011 to 61.9% in the first nine months of 2012. Selling prices are determined based on the currency conversion between the U.S. dollar and the local currency. In addition, gross profit margin is affected by sales mix – the ratio of higher margin products (tools, supplies, etc.) to lower margin products (leather). Operating expenses totaled $1.5 million in the first three quarters of 2012, up from $660,000 in the first three quarters of 2011, all attributable to the new stores' operations. Employee compensation is this segment's largest expense, followed by advertising and marketing expenses, shipping costs to customers, and rent.

Other Expenses

We paid $176,000 in interest on our debt in the first nine months of 2012, compared to $186,000 in the first nine months of 2011. Due to the reduction in cash on hand compared to last year, we recorded $7,000 in interest income on our cash balances in the nine months ended September 30, 2012 compared to $33,000 a year ago. We recorded income of $15,000 for currency fluctuations in the first three quarters of 2012. Comparatively, in the first three quarters of 2011, we recorded income of $7,000 for currency fluctuations.

Capital Resources, Liquidity and Financial Condition

On our consolidated balance sheet, total assets were $48.7 million at September 30, 2012, up $3.2 million from $45.5 million at year-end 2011. Total stockholders' equity increased from $34.4 million at December 31, 2011 to $35.4 million at September 30, 2012, the increase being attributable to earnings in the first three quarters of this year, partially offset by the cash dividend of $2.5 million paid to stockholders in April. Our current ratio decreased from 4.7 at December 31, 2011 to 3.9 at September 30, 2012 as current liabilities grew faster than current assets.

Our investment in inventory increased by $9.8 million from year-end 2011 to September 30, 2012. Inventory turnover reached an annualized rate of 2.77 times during the first nine months of 2012, less than 3.09 times for the first nine months of 2011. Inventory turnover was 3.29 times for all of 2011. We compute our inventory turns as sales divided by average inventory. As of September 30, 2012, our total inventory on hand was approximately 15% over our internal targets for optimal inventory levels. We have increased the amount of inventory carried in our stores to provide our customers with greater product selection and to promote continued sales growth. We are also stocking additional inventory to support our growing International Leathercraft segment. Further, while sales remain strong, we will continue to buy large quantities of our stock leathers at special prices as those opportunities present themselves in order to relieve pressure on our gross margins.

Trade accounts receivable was $1.1 million at September 30, 2012, down $250,000 from $1.3 million at year-end 2011. The average days to collect accounts for the first three quarters of 2012 were 47 days, down from 50 days for the first three quarters of 2011. We are monitoring our customer accounts very closely in order to minimize the risk of uncollectible accounts in the current economic environment.

Accounts payable increased to $2.6 million at September 30, 2012 compared to $1.6 million at year-end 2011, primarily due to the increase in inventory purchases during the first nine months of 2012. Accrued expenses increased $1.1 million from December 31, 2011 to September 30, 2012 due to the accrual of the litigation settlement amount. (See Note 7 to the consolidated financial statements included in Item 1 of this Report for additional information.)

During the first nine months of 2012, cash flow used by operating activities was $4.7 million. The increase in inventory of $9.8 million, offset by net income of $3.4 million, and the increase in accrued liabilities of $1.1 million accounted for the majority of the operating cash used in the nine months. By comparison, during the first nine months of 2011, cash flow provided by operating activities was $1.6 million. Net income of $3.1 million was offset by a reduction in accrued liabilities of $1.5 million and accounted for the majority of the operating cash provided in the first nine months.

Cash flow used in investing activities totaled $862,000 in the first nine months of 2012, consisting primarily of purchases of store fixtures and computer equipment and building construction in progress, partially offset by maturities of certificates of deposit. In the first three quarters of 2011, cash flow provided by investing activities totaled $246,000, consisting primarily of maturities of certificates of deposit, offset by purchases of store fixtures and computer equipment.

Cash flow used in financing activities totaled $1.7 million in the first nine months of 2012, consisting of a special one-time cash dividend of $2.5 million, partially offset by borrowings against the line of credit of $1 million less debt repayments of $152,000. Cash flow used by financing activities totaled $152,000 in the first nine months of 2011, consisting of debt repayments.

We expect to fund our operating and liquidity needs as well as our store growth from a combination of current cash balances, internally generated funds, and our revolving credit facility with JPMorgan Chase Bank.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

For disclosures about market risk affecting us, see Item 7A “Quantitative and Qualitative Disclosures About Market Risk” in our Annual Report on Form 10-K for fiscal year ended December 31, 2011. We believe that our exposure to market risks has not changed significantly since December 31, 2011.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

Our management team, under the supervision and with the participation of our principal executive officer and our principal financial officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as such term is defined under Rule 13a-15(e) and 15d-15(e) promulgated under the Securities Exchange Act of 1934, as amended, as of the last day of the fiscal period covered by this report, September 30, 2012. The term disclosure controls and procedures means our controls and other procedures that are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934, as amended, is accumulated and communicated to management, including our principal executive and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based on this evaluation, our principal executive officer and our principal financial officer concluded that, as of September 30, 2012, our disclosure controls and procedures were effective at a reasonable assurance level.

Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting (as such term is defined in Rules13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended), during the fiscal quarter ended September 30, 2012 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

The information contained in Note 7 to the consolidated financial statements included in Item 1 of this Report is hereby incorporated into this Item 1 by reference.

Table of Contents

Item 6. Exhibits.

Exhibit Number	Description
3.1	Certificate of Incorporation of The Leather Factory, Inc., and Certificate of Amendment to Certificate of Incorporation of The Leather Factory, Inc. filed as Exhibit 3.1 to Form 10-Q filed by Tandy Leather Factory, Inc. with the Securities and Exchange Commission on August 12, 2005 and incorporated by reference herein.
3.2	Bylaws of The Leather Factory, Inc., filed as Exhibit 3.5 to the Current Report on Form 8-K (Commission File No. 001-12368) filed by Tandy Leather Factory, Inc (f/k/a The Leather Factory, Inc.) with the Securities and Exchange Commission on July 14, 2004 and incorporated by reference herein.
10.1	Settlement Agreement, dated September 24, 2012, in the lawsuit entitled "Mark Barnes, Donna Cavota and Jerry Mercante on behalf of themselves and others similarly situated v. Tandy Leather Company, LP and The Leather Factory, LP", Case No.4: 11-cv-00335-A in the United States District Court, Northern District of Texas, Fort Worth Division, filed as Exhibit 10.1 to the Current Report on Form 8-K (Commission File No. 001-12368) filed by Tandy Leather Factory, Inc. with the Securities and Exchange Commission on September 28, 2012 and incorporated by reference herein.
*31.1	13a-14(a) or 15d-14(a) Certification by Jon Thompson, Chief Executive Officer and President.
*31.2	13a-14(a) or 15d-14(a) Certification by Shannon Greene, Chief Financial Officer and Treasurer.
*32.1	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.INS^	XBRL Instance Document.
101.SCH^	XBRL Taxonomy Extension Schema Document.
101.CAL^	XBRL Taxonomy Extension Calculation Document.
101.DEF^	XBRL Taxonomy Extension Definition Document.
101.LAB^	XBRL Taxonomy Extension Labels Document.
101.PRE^	XBRL Taxonomy Extension Presentation Document.

*Filed herewith.

^ XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	TANDY LEATHER FACTORY, INC. (Registrant)
Date: November 13, 2012	By: /s/ Jon Thompson Jon Thompson Chief Executive Officer and President
Date: November 13, 2012	By: /s/ Shannon L. Greene Shannon L. Greene Chief Financial Officer and Treasurer (Chief Accounting Officer)