TANDY LEATHER FACTORY INC
Form 10-Q
November 14, 2008

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, 2008

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) | (IRS Employer Identification Number) |

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one): Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [X]

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the 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 8, 2008 |
|---|---|
| Common Stock, par value $0.0024 per share | 10,989,092 |

TANDY LEATHER FACTORY, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2008

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

Tandy Leather Factory, Inc.
Consolidated Balance Sheets

| | September 30, 2008 (unaudited) | December 31, 2007 (audited) |
|---|---|---|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash | $8,523,574 | $6,310,396 |
| Certificates of deposit | 1,858,000 | - |
| Marketable securities | 400,000 | 500,000 |
| Accounts receivable-trade, net of allowance for doubtful accounts of $104,000 and $104,000 in 2008 and 2007, respectively | 1,959,430 | 2,538,816 |
| Inventory | 17,038,821 | 17,473,352 |
| Deferred income taxes | 249,274 | 256,938 |
| Other current assets | 974,662 | 1,102,836 |
| Total current assets | 31,003,761 | 28,182,338 |
| | | |
| PROPERTY AND EQUIPMENT, at cost | 15,169,776 | 11,793,317 |
| Less accumulated depreciation and amortization | (4,867,095) | (4,794,505) |
| | 10,302,681 | 6,998,812 |
| | | |
| GOODWILL | 981,904 | 990,536 |
| OTHER INTANGIBLES, net of accumulated amortization of $352,000 and $313,000 in 2008 and 2007, respectively | 345,666 | 384,134 |
| OTHER assets | 344,486 | 1,095,686 |
| | $42,978,498 | $37,651,506 |
| | | |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable-trade | $2,764,175 | $1,497,564 |
| Accrued expenses and other liabilities | 3,615,419 | 2,072,640 |
| Income taxes payable | 67,910 | 67,150 |
| Current maturities of long-term debt and capital lease obligations | 463,892 | 135,000 |
| Total current liabilities | 6,911,396 | 3,772,354 |
| | | |
| DEFERRED INCOME TAXES | 533,599 | 148,648 |
| | | |
| LONG-TERM DEBT, net of current maturities | 3,763,125 | 3,915,000 |
| CAPITAL LEASE OBLIGATION, net of current maturities | 396,526 | - |
| | | |
| 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; | | |
| 10,994,951 and 10,982,951 shares issued at 2008 and 2007, respectively; | | |
| 10,989,092 and 10,977,092 shares outstanding at 2008 and 2007, respectively | 26,388 | 26,359 |
| Paid-in capital | 5,456,823 | 5,419,477 |
| Retained earnings | 25,698,434 | 24,037,672 |
| Treasury stock (5,859 shares at cost) | (25,487) | (25,487) |
| Accumulated other comprehensive income | 217,694 | 357,483 |
| Total stockholders' equity | 31,373,852 | 29,815,504 |
| | $42,978,498 | $37,651,506 |

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

1

Tandy Leather Factory, Inc.
Consolidated Statements of Income
(Unaudited)
For the Three and Nine Months Ended September 30, 2008 and 2007

| | THREE MONTHS | | NINE MONTHS | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| NET SALES | $12,251,990 | $12,806,333 | $39,360,114 | $40,691,125 |
| COST OF SALES | 5,108,833 | 5,864,699 | 16,464,284 | 17,465,869 |
| Gross profit | 7,143,157 | 6,941,634 | 22,895,830 | 23,225,256 |
| OPERATING EXPENSES | 6,377,674 | 6,836,357 | 20,317,446 | 20,460,848 |
| INCOME FROM OPERATIONS | 765,483 | 105,277 | 2,578,384 | 2,764,408 |
| OTHER INCOME (EXPENSE): | | | | |
| Interest expense | (80,072) | (50,494) | (249,725) | (50,494) |
| Other, net | 25,672 | 272,658 | 332,355 | 349,172 |
| Total other income (expense) | (54,400) | 222,164 | 82,630 | 298,678 |
| INCOME BEFORE INCOME TAXES | 711,083 | 327,441 | 2,661,014 | 3,063,086 |
| PROVISION FOR INCOME TAXES | 290,069 | 155,835 | 1,000,252 | 1,148,438 |
| NET INCOME | $421,014 | $171,606 | $1,660,762 | $1,914,648 |
| NET INCOME PER COMMON SHARE-BASIC | $ 0.04 | $ 0.02 | $ 0.15 | $ 0.17 |
| NET INCOME PER COMMON SHARE-DILUTED | $ 0.04 | $ 0.02 | $ 0.15 | $ 0.17 |
| Weighted Average Number of Shares Outstanding: | | | | |
| Basic | 10,988,092 | 10,968,635 | 10,982,209 | 10,943,817 |
| Diluted | 11,073,942 | 11,152,731 | 11,072,717 | 11,157,013 |

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

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Tandy Leather Factory, Inc.
Consolidated Statements of Cash Flows
(Unaudited)
For the Nine Months Ended September 30, 2008 and 2007

| | 2008 | 2007 |
|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $1,660,762 | $1,914,648 |
| Adjustments to reconcile net income to net | | |
| cash provided by (used in) operating activities- | | |
| Depreciation & amortization | 758,364 | 470,832 |
| Loss on disposal of assets | 13,385 | - |
| Non-cash stock-based compensation | 22,875 | 22,876 |
| Deferred income taxes | 392,615 | (18,149) |
| Other | (131,157) | 233,465 |
| Net changes in assets and liabilities: | | |
| Accounts receivable-trade, net | 579,386 | 360,709 |
| Inventory | 434,531 | (3,202,032) |
| Income taxes | 760 | (580,218) |
| Other current assets | 128,174 | 98,716 |
| Accounts payable | 1,266,611 | 516,201 |
| Accrued expenses and other liabilities | 1,542,779 | (992,879) |
| Total adjustments | 5,008,323 | (3,090,478) |
| | | |
| Net cash provided by (used in) operating activities | 6,669,085 | (1,175,830) |
| | | |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of property and equipment | (3,272,993) | (5,084,908) |
| Payments in connection with businesses acquired | - | (650,000) |
| Proceeds from sale of assets | 39,556 | 25,339 |
| Decrease (increase) in other assets | 751,200 | (120,267) |
| Purchase of certificates of deposit | (1,858,000) | - |
| Proceeds from sale of marketable securities | 100,000 | - |
| | | |
| Net cash used in investing activities | (4,240,237) | (5,829,836) |
| | | |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from notes payable and long-term debt | - | 4,050,000 |
| Payments on long-term debt and notes payable | (84,375) | - |
| Payments on capital lease obligations | (145,795) | (100,550) |
| Proceeds from issuance of common stock | 14,500 | 73,860 |
| | | |
| Net cash provided by (used in) financing activities | (215,670) | 4,023,310 |
| | | |
| NET CHANGE IN CASH | 2,213,178 | (2,982,355) |
| | | |
| CASH, beginning of period | 6,310,396 | 6,739,891 |
| | | |

| | | |
|---|---|---|
| CASH, end of period | $8,523,574 | $3,757,534 |
| | | |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: | | |
| Interest paid during the period | $249,725 | $50,494 |
| Income taxes paid during the period, net of (refunds) | 634,749 | 1,758,519 |
| | | |
| NON-CASH INVESTING ACTIVITIES: | | |
| Equipment acquired under capital lease financing arrangements | 803,713 | - |

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

Tandy Leather Factory, Inc.
Consolidated Statements of Stockholders' Equity
For the Nine Months Ended September 30, 2008 and 2007

| | Number of Shares | Par Value | Paid-in Capital | Treasury Stock | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total | Comprehensive Income (Loss) |
|---|---|---|---|---|---|---|---|---|
| BALANCE, December 31, 2006 | 10,879,209 | $26,124 | $5,292,591 | $(25,487) | $20,949,540 | $80,475 | $26,323,243 | |
| Shares issued - stock options and warrants exercised | 89,883 | 216 | 73,644 | - | - | - | 73,860 | |
| Stock-based compensation | - | - | 22,876 | - | - | - | 22,876 | |
| Net income | - | - | - | - | 1,914,648 | - | 1,914,648 | $1,914,648 |
| Translation adjustment | - | - | - | - | - | 251,624 | 251,624 | 251,624 |
| BALANCE, September 30, 2007 | 10,969,092 | $26,340 | $5,389,111 | $(25,487) | $22,864,188 | $332,099 | $28,586,251 | |
| Comprehensive income for the nine months ended September 30, 2007 | | | | | | | | $2,166,272 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| BALANCE, December 31, 2007 | 10,977,092 | $26,359 | $5,419,477 | $(25,487) | $24,037,672 | $357,483 | $29,815,504 | |
| Shares issued - stock options exercised | 12,000 | 29 | 14,471 | - | - | - | 14,500 | |
| Stock-based compensation | - | - | 22,875 | - | - | - | 22,875 | |
| | - | - | - | - | 1,660,762 | - | 1,660,762 | $1,660,762 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Net income | | | | | | | | |
| Translation adjustment | - | - | - | - | - | (139,789) | (139,789) | (139,789) |
| | | | | | | | | |
| BALANCE, September 30, 2008 | 10,989,092 | $26,388 | $5,456,823 | $(25,487) | $25,698,434 | $217,694 | $31,373,852 | |

Comprehensive income for the nine months ended September 30, 2008 $1,520,973

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

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TANDY LEATHER FACTORY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. BASIS OF PRESENTATION AND CERTAIN SIGNIFICANT ACCOUNTING POLICIES

These financial statements include the accounts of Tandy Leather Factory, Inc. and its subsidiaries. Unless the context indicates otherwise, references to “we”, “us”, and “our” refer to the consolidated operations of Tandy Leather Factory, Inc. and its subsidiaries. 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) necessary to present fairly its financial position as of September 30, 2008 and December 31, 2007, and its results of operations and cash flows for the three and/or nine-month periods ended September 30, 2008 and 2007. Operating results for the three and nine-month periods ended September 30, 2008 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2008. 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, 2007.

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 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, 2008 | December 31, 2007 |
| Inventory on hand: | | |
| Finished goods held for sale | $15,330,890 | $16,482,845 |
| Raw materials and work in process | 438,828 | 633,188 |
| Inventory in transit | 1,269,103 | 357,319 |
| | $17,038,821 | $17,473,352 |

Goodwill and Other Intangibles. Statement of Financial Accounting Standards (“SFAS”) No. 142, "Goodwill and Other Intangible Assets" (“SFAS 142”) prescribes a two-phase process for impairment testing of goodwill, which is performed annually, absent indicators of impairment during the interim. 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, 2007, 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 nine months of 2008.

A summary of changes in our goodwill for the periods ended September 30, 2008 and 2007 is as follows:

| | Leather Factory | Tandy Leather | Total |
|---|---|---|---|
| Balance, December 31, 2006 | $362,733 | $383,406 | $746,139 |
| Acquisitions and adjustments | 225,000 | - | 225,000 |
| Foreign exchange gain/loss | 18,157 | - | 18,157 |
| Impairments | - | - | - |
| Balance, September 30, 2007 | $605,890 | $383,406 | $989,296 |

| | Leather Factory | Tandy Leather | Total |
|---|---|---|---|
| Balance, December 31, 2007 | $607,130 | $383,406 | $990,536 |
| Acquisitions and adjustments | - | - | - |
| Foreign exchange gain/loss | (8,632) | - | (8,632) |
| Impairments | - | - | - |
| Balance, September 30, 2008 | $598,498 | $383,406 | $981,904 |

Other intangibles consist of the following:

| | As of September 30, 2008 | | | As of December 31, 2007 | | |
|---|---|---|---|---|---|---|
| | Gross | Accumulated Amortization | Net | Gross | Accumulated Amortization | Net |
| Trademarks, Copyrights | $544,369 | $310,703 | $233,666 | $544,369 | $283,485 | $260,884 |
| Non-Compete Agreements | 153,000 | 41,000 | 112,000 | 153,000 | 29,750 | 123,250 |
| | $697,369 | $351,703 | $345,666 | $697,369 | $313,235 | $384,134 |

We recorded amortization expense of $38,468 during the first nine months of 2008 compared to $38,718 during the first nine months of 2007. All of our intangible assets are subject to amortization under SFAS 142. Based on the current amount of intangible assets subject to amortization, the estimated amortization expense for each of the succeeding five years is as follows:

| | Wholesale Leathercraft | Retail Leathercraft | Total |
|---|---|---|---|
| 2008 | $20,954 | $30,337 | $51,291 |
| 2009 | 20,954 | 30,337 | 51,291 |
| 2010 | 20,954 | 30,337 | 51,291 |
| 2011 | 20,027 | 30,337 | 50,364 |
| 2012 | 1,250 | 30,337 | 31,587 |

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.

Recent Accounting Pronouncements. In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, Fair Value Measurements ("SFAS 157"). SFAS 157 defines fair value, creates a framework within GAAP for measuring fair value, and expands disclosures about fair value measurements. In defining fair value, SFAS 157 emphasizes a market-based measurement approach that is based on the assumptions that market participants would use in pricing an asset or liability. SFAS 157 does not require any new fair value measurements, but does generally apply to other accounting pronouncements that require or permit fair value measurements. In February 2008, FASB issued FSP FAS 157-2, Effective Date of FASB Statement No. 157, which delays for one year the effective date of SFAS 157 for most nonfinancial assets and nonfinancial liabilities. Nonfinancial instruments affected by this deferral include assets and liabilities such as reporting units measured at fair value in a goodwill impairment test and nonfinancial assets acquired and liabilities assumed in a business combination. Effective January 1, 2008, we adopted SFAS 157 for financial assets and financial liabilities recognized at fair value on a recurring basis. The adoption of SFAS 157 for these items did not have a material impact on our financial position, results of operations and cash flows.

In February 2007, FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities — including an amendment of FASB Statement No. 115. This statement permits entities to choose to measure many financial instruments and certain other items at fair value. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, including interim periods within that fiscal year. We did not elect the fair value option for any of our existing financial instruments as of September 30, 2008 and we have not determined whether or not we will elect this option for financial instruments we may acquire in the future.

In December 2007, FASB issued SFAS No. 141 (revised 2007), Business Combinations ("SFAS 141R"). SFAS 141R defines a business combination as a transaction or other event in which an acquirer obtains control of one or more businesses. Under SFAS 141R, all business combinations are accounted for by applying the acquisition method (previously referred to as the purchase method), under which the acquirer measures all identified assets acquired, liabilities assumed, and noncontrolling interests in the acquiree at their acquisition date fair values. Certain forms of contingent consideration and certain acquired contingencies are also recorded at their acquisition date fair values. SFAS 141R also requires that most acquisition related costs be expensed in the period incurred. SFAS 141R is effective for us in January 2009. SFAS 141R will change our accounting for business combinations on a prospective basis.

In December 2007, FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51 ("SFAS 160"). SFAS 160 requires a company to recognize noncontrolling interests (previously referred to as "minority interests") as a separate component in the equity section of the consolidated statement of financial position. It also requires the amount of consolidated net income specifically attributable to the noncontrolling interest be identified in the consolidated statement of income. SFAS 160 also requires changes in ownership interest to be accounted for similarly, as equity transactions; and when a subsidiary is deconsolidated, any retained noncontrolling equity investment in the former subsidiary and the gain or loss on the deconsolidation of the subsidiary be measured at fair value. SFAS 160 is effective for us in January 2009. We are currently evaluating the impact, if any, SFAS 160 will have on our financial position, results of operations and cash flows.

In March 2008, FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities ("SFAS 161"). SFAS 161 requires a company with derivative instruments to disclose information that should enable financial statement users to understand how and why a company uses derivative instruments, how derivative instruments and related hedged items are accounted for under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and how derivative instruments and related hedged items affect a company's financial position, financial performance, and cash flows. SFAS 161 is effective for us in January 2009.

2. STOCK-BASED COMPENSATION

We have one stock option plan which provides for stock option grants to non-employee directors. No options have been awarded under this plan as of September 30, 2008. We maintained two other stock option plans from 1995 until they expired in 2005 which provided for stock option grants to officers, key employees and non-employee directors. 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 on the date the option was granted and no option has a term in excess of ten years. Additionally, options vest and become exercisable either six months from the option grant date or in equal installments over a five year period. Prior to fiscal 2006, we accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations and provided the required pro forma disclosures of SFAS No. 123, Accounting for Stock-Based Compensation.

On January 1, 2006, we adopted SFAS No. 123(R), Share-Based Payment, and elected to adopt the standard using the modified prospective transition method. Under this transition method, compensation cost associated with stock options recognized in 2006 includes: (1) amortization related to the remaining unvested portion of all share based payments granted prior to, but not vested as of December 31, 2005, based on the grant date fair value estimated in accordance with the original pro forma footnote disclosure provisions of FASB Statement No. 123 and (2) amortization related to all share based payments granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). Accordingly, stock compensation award expense is recognized over the requisite service period using the straight-line attribution method. We recognized share based compensation expense of $7,625 for each of the quarters ended September 30, 2008 and 2007, respectively, and $22,875 for each of the nine-month periods ended September 30, 2008 and 2007, respectively, as a component of operating expenses.

During the nine months ended September 30, 2008 and 2007, the stock option activity under our stock option plans was as follows:

| | Weighted Average Exercise Price | # of shares | Weighted Average Remaining Contractual Term (in yrs) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding, January 1, 2007 | $2.050 | 296,200 | | |
| Granted | - | - | | |
| Cancelled | - | - | | |
| Exercised | 1.466 | 51,500 | | |
| Outstanding, September 30, 2007 | $2.180 | 244,700 | 4.35 | $289,420 |
| Exercisable, September 30, 2007 | $2.050 | 228,700 | 4.22 | $256,380 |
| | | | | |
| Outstanding, January 1, 2008 | $2.11 | 236,700 | | |
| Granted | - | - | | |
| Cancelled | - | - | | |
| Exercised | 1.21 | 12,000 | | |
| Outstanding, September 30, 2008 | $2.16 | 224,700 | 3.46 | $262,001 |
| Exercisable, September 30, 2008 | $2.15 | 222,700 | 3.44 | $259,461 |

Other information pertaining to option activity during the nine-month periods ended September 30, 2008 and 2007 are as follows:

| | September 30, 2008 | September 30, 2007 |
|---|---|---|
| Weighted average grant-date fair value of stock options granted | N/A | N/A |
| Total fair value of stock options vested | $30,500 | $30,500 |
| Total intrinsic value of stock options exercised | $8,779 | $43,640 |

As of September 30, 2008 and 2007, there was $10,000 and $30,000, respectively, of total unrecognized compensation cost related to nonvested stock options, which is expected to be recognized over a remaining weighted average vesting period of two years.

3. 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, 2008 and 2007:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Numerator: | | | | |
| Net income | $421,014 | $171,606 | $1,660,762 | $1,914,648 |
| Numerator for basic and diluted earnings per share | 421,014 | 171,606 | 1,660,762 | 1,914,648 |
| Denominator: | | | | |
| Weighted-average shares outstanding-basic | 10,988,092 | 10,968,635 | 10,982,209 | 10,943,817 |
| | | | | |
| Effect of dilutive securities: | | | | |
| Stock options | 85,850 | 170,874 | 90,508 | 187,064 |
| Warrants | - | 13,222 | - | 26,132 |
| Dilutive potential common shares | 85,850 | 184,096 | 90,508 | 213,196 |
| Denominator for diluted earnings per share-weighted-average shares | 11,073,942 | 11,152,731 | 11,072,717 | 11,157,013 |
| | | | | |
| Basic earnings per share | $0.04 | $0.02 | $0.15 | $0.18 |
| Diluted earnings per share | $0.04 | $0.02 | $0.15 | $0.17 |

The net effect of converting stock options and warrants to purchase 155,700 shares of common stock at exercise prices less than the average market prices has been included in the computations of diluted EPS for the quarter and nine months ended September 30, 2008, respectively.

4. SEGMENT INFORMATION

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

a. Wholesale Leathercraft, which consists of a chain of warehouse distribution units 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;

c. International Leathercraft, sells to both wholesale and retail customers. It carries the same products as North American stores. We started this operation in February 2008 and have one store located in Northampton, United Kingdom; and

d. Other, which consists of Roberts, Cushman and Co., a producer of decorative hat trims sold directly to hat manufacturers.

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.

| | Wholesale Leathercraft | Retail Leathercraft | International Leathercraft | Other | Total |
|---|---|---|---|---|---|

| | | | | | |
|---|---|---|---|---|---|
| For the quarter ended September 30, 2008 | | | | | |
| Net sales | $5,997,550 | $5,726,164 | $324,081 | $204,195 | $12,251,990 |
| Gross profit | 3,377,119 | 3,453,759 | 224,563 | 87,716 | 7,143,157 |
| Operating earnings | 435,790 | 234,743 | 55,008 | 39,942 | 765,483 |
| Interest expense | (80,072) | - | - | - | (80,072) |
| Other income (expense), net | 86,999 | 2,887 | (64,214) | - | 25,672 |
| Income before income taxes | 442,717 | 237,630 | (9,206) | 39,942 | 711,083 |
| | | | | | |
| Depreciation and amortization | 228,936 | 30,644 | 3,684 | 209 | 263,473 |
| Fixed asset additions | 148,597 | 27,404 | 19,018 | - | 195,019 |
| Total assets | $36,495,134 | $5,603,759 | $695,395 | $184,210 | $42,978,498 |
| | | | | | |
| For the quarter ended September 30, 2007 | | | | | |
| Net sales | $6,940,484 | $5,657,198 | - | $208,651 | $12,806,333 |
| Gross profit | 3,608,272 | 3,254,075 | - | 79,287 | 6,941,634 |
| Operating earnings | 32,686 | 58,780 | - | 13,811 | 105,277 |
| Interest expense | (50,494) | - | - | - | (50,494) |
| Other income (expense), net | 264,792 | 7,866 | - | - | 272,658 |
| Income before income taxes | 246,984 | 66,646 | - | 13,811 | 327,441 |
| | | | | | |
| Depreciation and amortization | 181,113 | 35,050 | - | 2,477 | 218,640 |
| Fixed asset additions | 4,657,769 | 74,257 | - | - | 4,732,026 |
| Total assets | $31,929,070 | $5,548,815 | - | $167,555 | $37,645,440 |

7

| | Wholesale Leathercraft | Retail Leathercraft | International Leathercraft | Other | Total |
|---|---|---|---|---|---|
| For the nine months ended September 30, 2008 | | | | | |
| Net sales | $19,953,958 | $18,232,364 | $559,641 | $614,151 | $39,360,114 |
| Gross profit | 10,997,820 | 11,260,249 | 366,572 | 271,190 | 22,895,830 |
| Operating earnings | 1,084,364 | 1,421,064 | 6,091 | 66,866 | 2,578,384 |
| Interest expense | (249,725) | - | - | - | (249,725) |
| Other income (expense), net | 401,027 | 2,486 | (71,158) | - | 332,355 |
| Income before income taxes | 1,235,666 | 1,423,550 | (65,067) | 66,866 | 2,661,014 |
| | | | | | |
| Depreciation and amortization | 660,311 | 94,401 | 10,081 | 1,266 | 766,058 |
| Fixed asset additions | 3,155,361 | 91,161 | 25,409 | 1,062 | 3,272,993 |
| Total assets | $36,495,134 | $5,603,759 | $695,395 | $184,210 | $42,978,498 |
| | | | | | |
| For the nine months ended September 30, 2007 | | | | | |
| Net sales | $22,057,123 | $17,753,614 | - | $880,388 | $40,691,125 |
| Gross profit | 12,378,185 | 10,482,976 | - | 364,095 | 23,225,256 |
| Operating earnings | 1,790,257 | 878,492 | - | 95,659 | 2,764,408 |
| Interest expense | (50,494) | - | - | - | (50,494) |
| Other income (expense), net | 336,641 | 12,531 | - | - | 349,172 |
| Income before income taxes | 2,076,404 | 891,023 | - | 95,659 | 3,063,086 |
| | | | | | |
| Depreciation and amortization | 341,974 | 127,862 | - | 996 | 470,832 |
| Fixed asset additions | 4,892,019 | 192,687 | - | 200 | 5,084,906 |
| Total assets | $31,929,070 | $5,548,815 | - | $167,555 | $37,645,440 |

Net sales for geographic areas for the three and nine months ended September 30, 2008 and 2007 were as follows:

| Three months ended September 30, | 2008 | 2007 |
|---|---|---|
| United States | $10,511,250 | $11,423,156 |
| Canada | 1,078,747 | 1,072,842 |
| All other countries | 661,993 | 310,335 |
| | $12,251,990 | $12,806,333 |

| Nine months ended September 30, | 2008 | 2007 |
|---|---|---|
| United States | $34,124,413 | $36,194,509 |
| Canada | 3,550,955 | 3,274,464 |
| All other countries | 1,684,746 | 1,222,152 |
| | $39,360,114 | $40,691,125 |

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, 2008 or 2007. We do not have any significant long-lived assets outside of the United States.

5. MARKETABLE SECURITIES

Our investments are considered available-for-sale and consist of one auction rate security ("ARS"). ARS are intended to provide liquidity via an auction process that resets the applicable interest rate at predetermined calendar intervals, allowing investors to either roll over their holdings or gain immediate liquidity by selling such interests at par. We have classified this investment as a current asset because we sold it at par in October 2008.

6. 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 195,000 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 and accrues interest at a rate of 7.10% per annum.

At September 30, 2008 and 2007, the amount outstanding under the above agreement and other long-term debt consisted of the following:

| | 2008 | 2007 |
|---|---|---|
| Credit Agreement with JPMorgan Chase Bank – collateralized by real estate; payable as follows: | | |
| Line of Credit Note dated July 31, 2007 in the principal amount of $4,050,000; rolled into a 10-year term note on April 30, 2008 - $16,875 monthly principal payments plus interest at 7.1% per annum; matures April 30, 2018 | $ 3,965,625 | $ 4,050,000 |
| Capital lease secured by HVAC equipment – total monthly principal and interest payments of $24,328 at approximately 5.7% interest per annum, matures February 2011 | 657,918 | - |
| | 4,623,543 | 4,050,000 |
| Less - Current maturities | 463,892 | 84,375 |
| | $4,159,651 | $3,965,625 |

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

Our Business

We are the world's largest specialty retailer 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 American Stock Exchange under the symbol "TLF." We operate our business in four 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, International Leathercraft, which operates combination retail/wholesale stores outside of North America under the trade name, Tandy Leather Factory, and Other. See Note 4 to the Consolidated Financial Statements for additional information concerning our segments.

Our Wholesale Leathercraft segment operates 30 company-owned wholesale stores in 20 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 group.

Our Retail Leathercraft segment operates company-owned Tandy Leather retail stores in 34 states and five Canadian provinces. Tandy Leather, the oldest and best-known supplier of leather and related supplies used in the leathercraft industry, has been the primary leathercraft resource for decades. Tandy Leather's products include quality tools, leather, accessories, kits and teaching materials. In 2002, we began expanding Tandy Leather's industry presence by opening retail stores. As of November 1, 2008, we were operating 73 Tandy Leather retail stores located throughout the United States and Canada.

Our International Leathercraft segment operates one company-owned store in Northampton, United Kingdom. The store, which opened in February 2008, functions as a combination retail and wholesale store.

Our "Other" segment consists of Roberts, Cushman and Co., a wholly-owned subsidiary that custom designs and distributes decorative hat trims for headwear manufacturers.

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 year ended December 31, 2007.

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 2007 for additional information concerning these and other uncertainties that could negatively impact the Company.

Ø We believe that the rise in oil and natural gas prices will increase the costs of the goods that we sell, including the costs of shipping those goods from the manufacturer to our stores and customers. We further believe that a reduction in oil and gas prices does not guarantee a reduction in the costs of the goods that we sell as our suppliers may not pass those cost reductions on to us.

Various oils used to manufacture certain leather and leathercrafts are derived from petroleum and natural gas. Also, the carriers who transport our goods rely on petroleum-based fuels to power their ships, trucks and trains. They are likely to pass their increased costs on to us but are not obligated to pass their decreased costs on to us. We are unsure how much of the cost increases we will be able to pass on to our customers.

Ø Continued weakness in the economy in the United States, as well as abroad, may cause our sales to decrease or not to increase or adversely affect the prices charged for our products. Furthermore, negative trends in general consumer-spending levels, including the impact of the availability and level of consumer debt and levels of consumer confidence could adversely affect our sales.

General economic factors that are beyond our control impact our forecasts and actual performance. These factors include interest rates, recession, inflation, deflation, consumer credit availability, consumer debt levels, tax rates and policy, unemployment trends and other matters that influence consumer confidence and spending.

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, 2008 and 2007

The following tables present selected financial data of each of our four segments for the quarters ended September 30, 2008 and 2007. Certain prior year amounts have been reclassified to conform to the current year presentation.

| | Quarter Ended September 30, 2008 | | Quarter Ended September 30, 2007 | |
|---|---|---|---|---|
| | Sales | Operating Income | Sales | Operating Income |
| Wholesale Leathercraft | $5,997,550 | $435,791 | $6,940,484 | $32,686 |
| Retail Leathercraft | 5,726,164 | 234,743 | 5,657,198 | 58,780 |
| International Leathercraft | 324,081 | 55,008 | - | - |
| Other | 204,195 | 39,941 | 208,651 | 13,811 |
| Total Operations | $12,251,990 | $765,483 | $12,806,333 | $105,277 |

Consolidated net sales for the quarter ended September 30, 2008 decreased $554,000 or 4%, compared to the same period in 2007. Retail Leathercraft contributed $69,000 of additional sales, offset with a sales decrease of $942,000 and $4,000 in Wholesale Leathercraft and Other, respectively. International Leathercraft added new sales of $324,000 in this year's third quarter. Operating income on a consolidated basis for the quarter ended September 30, 2008 was up 627% or $660,000 over the third quarter of 2007, as a result of the increase in gross profit margin and the reduction in overall operating expenses.

The following table shows in comparative form our consolidated net income for the third quarters of 2008 and 2007:

| | 2008 | 2007 | % Change |
|---|---|---|---|
| Net income | $421,014 | $171,606 | 145.3% |

Wholesale Leathercraft

Our Wholesale Leathercraft operation consists of 30 wholesale stores and our National Account group. The following table presents the combined sales mix by customer categories for the quarters ended September 30, 2008 and 2007:

| | Quarter ended | |
|---|---|---|
| Customer Group | 09/30/08 | 09/30/07 |
| RETAIL (end users, consumers, individuals) | 19% | 21% |
| INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.) | 6% | 8% |
| WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.) | 39% | 43% |
| MANUFACTURERS | 10% | 13% |
| NATIONAL ACCOUNTS | 26% | 15% |
| | 100% | 100% |

Net sales were down for the third quarter of 2008, as compared to the corresponding period of 2007, as follows:

| | Quarter Ended 09/30/08 | Quarter Ended 09/30/07 | $ change | % change |
|---|---|---|---|---|
| Same store sales (30) | $5,289,155 | $6,157,021 | $(867,866) | (14.1)% |
| National account group | 708,395 | 783,463 | (75,068) | (9.6)% |
| | $5,997,550 | $6,940,484 | $(942,934) | (13.6)% |

Our same store sales declined 14% in the third quarter of 2008, as compared with the same period in 2007. Compared to the third quarter of 2007, sales decreased in all customer categories due to the general economic conditions in the U.S. Sales to our National Account customers were down 10% for the quarter compared to the same quarter last year as we were unable to replace last year's third quarter sales to Wal-Mart with sales to other customers this quarter. Wal-Mart ceased being a customer in the first quarter of 2008.

Operating income for Wholesale Leathercraft during the quarter ended September 30, 2008 increased by $403,000, an improvement of more than 13 times operating income in the comparative 2007 quarter. Operating expenses as a percentage of sales were 49.0%, down $600,000 from the third quarter of 2007. Personnel costs, including compensation, employment taxes, insurance and 401(k) benefits, decreased $300,000 in the quarter as we are keeping our employee headcount low without sacrificing production and customer service. Advertising expenses decreased $150,000, as we are doing more with electronic mail advertising as opposed to hard copy mailings. Outside services decreased $90,000 due to the elimination of various consulting services. Rent expense decreased $90,000 due to the move of our corporate offices and support units to a company-owned facility at the end of the first quarter of 2008. Freight out is down $60,000 due to the reduction in sales this quarter. In addition, purchases of office and shipping supplies in our stores and support departments decreased $50,000 in the current quarter as well. These reductions in operating expenses were partially offset by an increase in depreciation expense of $50,000, the cause of which is the building and various equipment placed in service at the end of the first quarter of 2008, as well as an increase in telephone and utility expense totaling $70,000.

Retail Leathercraft

Our Retail Leathercraft operation consists of 73 Tandy Leather retail stores at September 30, 2008, compared to 71 stores at September 30, 2007. Net sales were up approximately 1% for the third quarter of 2008 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 09/30/08 | Qtr Ended 09/30/07 | $ Incr (Decr) | % Incr (Decr) |
|---|---|---|---|---|---|
| Same (existing) store sales | 70 | $5,588,514 | $5,654,320 | $(65,806) | (1.2)% |
| New store sales | 3 | 137,650 | 2,878 | 134,772 | N/A |
| Total sales | 73 | $5,726,164 | $5,657,198 | $68,966 | 1.2% |

The following table presents sales mix by customer categories for the quarters ended September 30, 2008 and 2007 for our Retail Leathercraft operation:

| | Quarter Ended | |
|---|---|---|
| Customer Group | 09/30/08 | 09/30/07 |
| RETAIL (end users, consumers, individuals) | 61% | 62% |
| INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.) | 9% | 7% |
| WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.) | 29% | 28% |
| NATIONAL ACCOUNTS | - | - |
| MANUFACTURERS | 1% | 3% |
| | 100% | 100% |

Sales to our Retail, Institution, and Wholesale customer groups in the third quarter of 2008 increased compared to the third quarter of 2007, while sales to our Manufacturer customer group declined. These sales trends are consistent throughout the company – that is, our retail business appears to be holding fairly steady while our wholesale business has declined. We believe the weak economy is the primary reason for these sales trends. The retail stores averaged approximately $27,000 in sales per month for the third quarter of 2008.

Operating income in the third quarter of 2008 increased $176,000 to 4.1% of sales, compared to 1.0% of sales in the third quarter of 2007. Our gross margin improved from 57.5% to 60.3% due to the increase in retail sales, which brings a higher gross profit margin per sales dollar, and a reduction in sales to manufacturers, which brings a lower gross profit margin per sales dollar. Operating expenses as a percentage of sales decreased slightly from 56.5% to 56.2%.

International Leathercraft

Sales totaled $324,000 for the third quarter of 2008, all of which were generated from our new store located in the UK. The store was opened in February 2008. Gross profit margin was 69.3%. Operating expenses totaled $170,000, with the largest contributors being employee compensation ($40,000), advertising ($25,000), shipping to customers ($25,000) and rent ($15,000).

Other (Roberts, Cushman)

Sales decreased $4,000 or 2.1% for the third quarter of 2008. Gross profit margin as a percentage of sales improved to 42.9% compared to 38.0% in the comparable quarter in 2007. Operating income increased $26,000 due to the gross profit improvement and a reduction in personnel.

Other Expenses

We paid $80,000 in interest expense in the third quarter of 2008 on the bank debt related to the building purchase, compared to $50,000 in the third quarter last year. We earned $31,000 during the third quarter of 2008 in interest income, up from last year's third quarter interest income earned of $27,000, due to the increase in cash. We recorded $30,000 in expense during the third quarter of 2008 related to currency fluctuations from our Canadian and UK operations. Comparatively, in the third quarter of 2007, we recorded income of $6,000 for currency fluctuations.

Nine Months Ended September 30, 2008 and 2007

The following table presents selected financial data of each of our four segments for the nine months ended September 30, 2008 and 2007:

| | Nine Months Ended September 30, 2008 | | Nine Months Ended September 30, 2007 | |
|---|---|---|---|---|
| | Sales | Operating Income | Sales | Operating Income |
| Wholesale Leathercraft | $19,953,958 | $1,084,364 | $22,057,123 | $1,790,257 |
| Retail Leathercraft | 18,232,364 | 1,421,064 | 17,753,614 | 878,492 |
| International Leathercraft | 559,641 | 6,091 | - | - |
| Other | 614,151 | 66,865 | 880,388 | 95,659 |
| Total Operations | $39,360,114 | $2,578,384 | $40,691,125 | $2,764,408 |

Consolidated net sales for the nine months ended September 30, 2008 were down 3%, or $1.3 million, compared to the same period in 2007. Retail Leathercraft contributed additional sales of $478,000, offset by a combined sales decrease of $2.4 million from Wholesale Leathercraft and Other. International Leathercraft added new sales of $559,000. Operating income on a consolidated basis for the nine months ended September 30, 2008 was down 6.7% or $186,000 compared to the first nine months of 2007.

The following table shows in comparative form our consolidated net income for the first three quarters of 2008 and 2007:

| | 2008 | 2007 | % change |
|---|---|---|---|
| Net income | $1,660,762 | $1,914,648 | (13.3)% |

Wholesale Leathercraft

Net sales decreased 9.5%, or $2.1 million, for the first nine months of 2008, as compared to the corresponding period of 2007, as follows:

| | Nine Months Ended 09/30/08 | Nine Months Ended 09/30/07 | $ Change | % Change |
|---|---|---|---|---|
| Same store sales (29) | $16,911,426 | $18,729,902 | $(1,818,476) | (9.7)% |
| New store (1) | 438,757 | 553,451 | (114,694) | (20.7)% |
| National account group | 2,603,775 | 2,773,770 | (169,995) | (6.1)% |
| | $19,953,958 | $22,057,123 | $(2,103,165) | (9.5)% |

The following table presents the combined sales mix by customer categories for the nine months ended September 30, 2008 and 2007:

| | Nine Months Ended | |
|---|---|---|
| Customer Group | 09/30/08 | 09/30/07 |
| RETAIL (end users, consumers, individuals) | 25% | 22% |
| INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.) | 8% | 8% |
| WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.) | 41% | 43% |

| | | |
|---|---|---|
| MANUFACTURERS | 8% | 15% |
| NATIONAL ACCOUNTS | 18% | 12% |
| | 100% | 100% |

Operating income for Wholesale Leathercraft at the end of the first three quarters of 2008 decreased by $705,000 from the comparative 2007 period, a decline of 39.4%. Operating expenses decreased $674,000 for the first nine months of 2008, but were up as a percentage of sales from 48.0% in the first nine months of 2007 to 49.7% due to the decrease in sales.

Retail Leathercraft

Net sales were up approximately 3% for the first three quarters of 2008 over the same period last year.

| | # Stores | Nine Months Ended 09/30/08 | Nine Months Ended 09/30/07 | $ Incr (Decr) | % Incr (Decr) |
|---|---|---|---|---|---|
| Same (existing) store sales | 64 | $17,060,659 | $17,344,767 | $(284,108) | (1.6)% |
| New store sales | 9 | 1,171,705 | 408,847 | 762,858 | N/A |
| Total sales | 73 | $18,232,364 | $17,753,614 | $478,750 | 2.7% |

The following table presents sales mix by customer categories for the nine months ended September 30, 2008 and 2007 for our Retail Leathercraft operation:

| | Nine Months Ended | |
|---|---|---|
| Customer Group | 09/30/08 | 09/30/07 |
| RETAIL (end users, consumers, individuals) | 63% | 63% |
| INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.) | 8% | 8% |
| WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.) | 28% | 26% |
| NATIONAL ACCOUNTS | - | - |
| MANUFACTURERS | 1% | 3% |
| | 100% | 100% |

The retail stores averaged approximately $28,000 in sales per month for the first nine months of 2008 compared to a monthly average of $31,000 in the first nine months of 2007.

Operating income for the first nine months of 2008 increased $543,000 from the comparative 2007 period and as a percentage of sales, from 4.9% in the first three quarters of 2007 to 7.8% in the first three quarters of 2008. Gross margin improved from 59.1% to 61.7% due to an increase in retail sales and the high margins associated with that selling level. Operating expenses as a percentage of sales decreased slightly from 54.1% to 53.9% during the first nine months of 2008 as compared to the same period of 2007.

International Leathercraft

Sales totaled $559,000 for the first nine months of 2008, generated from our new store located in the UK, which opened in February 2008. Gross profit margin was 65.5%, which is slightly higher than the comparable U.S. stores. The store's higher profit margin is primarily due to the store's unique sales mix and the level at which we set our selling prices in the UK. We establish such levels to compensate for the higher cost of doing business overseas compared to the US. We do not expect the gross margins to maintain this level in the future. Operating expenses totaled $360,000, and the operating income generated year-to-date totaled $6,000.

Other (Roberts, Cushman)

Sales decreased $266,000 in the first nine months of 2008 compared to the same period in 2007. Gross profit margins decreased by $92,000 and operating margin decreased by $29,000. Operating expenses decreased by $64,000 in the first three quarters of 2008 compared to 2007.

Other Expenses

We paid $250,000 in interest expense in the first nine months of 2008 on our debt related to our building purchase compared to $50,000 in interest expense in the first nine months of 2007. We earned $103,000 in interest income in the nine months ended September 30, 2008, down slightly from last year's interest income of $108,000 due to reductions in interest rates. We recorded $9,000 in expense during the first three quarters of 2008 for currency fluctuations from our Canadian and UK operations. Comparatively, in the first nine months of 2007, we recorded income of $1,000 for currency fluctuations.

Capital Resources, Liquidity and Financial Condition

On our consolidated balance sheet, total assets increased from $37.6 million at year-end 2007 to $42.9 million at September 30, 2008. The increase in cash, certificates of deposits and property, offset partially by the decrease in accounts receivable and inventory, accounted for the increase. Total stockholders' equity increased from $29.8 million at December 31, 2007 to $31.3 million at September 30, 2008. Most of the increase was attributable to earnings in the first three quarters of this year. Our current ratio fell from 7.5 at December 31, 2007 to 4.5 at September 30, 2008 due to the increase in accounts payable and accrued expenses.

Our investment in inventory decreased by $434,000 at September 30, 2008 from year-end 2007. Inventory on hand decreased $1.3 million, but was partially offset by the amount of inventory on its way to us at September 30. The large amount of inventory in transit is reasonable at this time of year as we stock for the fourth quarter and Christmas shopping season. Inventory turnover increased to an annualized rate of 3.04 times during the first three quarters of 2008, from 2.86 times for the same period in 2007. Inventory turnover was 3.19 times for all of 2007. We compute our inventory turns as sales divided by average inventory. At the end of the third quarter of 2008, our total inventory on hand was less than 1% above our internal targets for optimal inventory levels. We expect inventory to remain fairly stable for the remainder of the year.

Trade accounts receivable was $1.9 million at September 30, 2008, down $580,000 from $2.6 million at year-end 2007. The average days to collect accounts for the first nine months of 2008 were 56 days, up slightly from the first nine months of 2007 of 55 days. We continue to tighten our credit policy given the current economic environment and are carefully analyzing our customers with open accounts to ensure collectability of the accounts.

Accounts payable increased $1.2 million to $2.7 million at the end of September 2008, due to an intentional slowdown of payments to vendors accomplished by our efforts to take full advantage of the payment terms. Accrued expenses and other liabilities increased $1.5 million, the majority of which represents the increase in inventory in transit to us at September 30, 2008 compared to December 31, 2007.

During the first three quarters of 2008, cash flow provided by operating activities was $6.6 million. The increase in accounts payable and accrued expenses and net income accounted for the majority of the cash provided. Cash flow used in investing activities totaled $4.1 million, consisting of $3 million in fixed asset purchases, the majority of which was the improvements to the building, and the increase in certificates of deposit, offset partially by the decrease in other assets. Cash flow used by financing activities totaled $216,000, consisting of payments on our capital lease of $146,000 and payments on our building debt of $85,000, offset partially by proceeds from employee stock option exercises totaling $15,000.

We expect to fund our operating and liquidity needs as well as the planned expansion of Tandy Leather's retail store chain from a combination of current cash balances and internally generated funds.

## 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, 2007. Our exposure to market risks has not changed significantly since December 31, 2007.

## 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) 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, 2008. 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, 2008, 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 during the fiscal quarter ended September 30, 2008 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information about purchases we have made of our common stock during the quarter ended September 30, 2008:

ISSUER PURCHASES OF EQUITY SECURITIES

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|---|---|---|---|---|
| July 1 through July 31 | - | - | - | - |
| August 1 through August 31 | - | - | - | - |
| September 1 through September 30 | - | - | - | 486,790 (1) |
| Total | - | - | - | 486,790 (1) |

(1) On September 9, 2008, our Board of Directors approved a limited stock repurchase plan whereby all non-officer participants in The Leather Factory, Inc. Stock Ownership Plan (the "ESOP") would have the option of selling the shares of our common stock distributed to them upon termination of the ESOP back to us. The option will remain open to the non-officer participants for a period of sixty days beginning on September 26, 2008 and ending on November 25, 2008. The purchase price of the shares will be calculated at a price-per-share equal to the closing price of a share of our common stock on the American Stock Exchange on the business day each non-officer participant notifies the ESOP administrator of his or her intent to sell his or her shares to us. As of September 30, 2008, we had not repurchased any of our shares in connection with this repurchase offer.

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 3.2 to the Registration Statement on Form SB-2 of The Leather Factory, Inc. (Commission File No. 33-81132), filed with the Securities and Exchange Commission on July 5, 1994 and incorporated by reference herein. |
| 4.1 | Financial Advisor's Warrant Agreement, dated February 24, 2004, between The Leather Factory, Inc. and Westminster Securities Corporation filed as Exhibit 4.1 to Form 10-Q filed by The Leather Factory, Inc. with the Securities and Exchange Commission on May 14, 2004 and incorporated by reference herein. |
| *31.1 | 13a-14(a) Certification by Ronald C. Morgan, Chief Executive Officer and President. |
| *31.2 | 13a-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. |

*Filed herewith.

## 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.<br>(Registrant) |
| Date: November 14, 2008 | By: /s/ Ronald C. Morgan<br>Ronald C. Morgan<br>Chief Executive Officer |
| Date: November 14, 2008 | By: /s/ Shannon L. Greene<br>Shannon L. Greene<br>Chief Financial Officer and Treasurer (Chief Accounting Officer) |

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