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

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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.

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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.

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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.

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.

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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.

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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.

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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.

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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.

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	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				