

TANDY LEATHER FACTORY INC
Form 10-Q
November 15, 2010

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

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2010

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
(State or other Jurisdiction of Incorporation or
Organization)

75-2543540
(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 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 a shorter period that the registrant was required to submit and post such files). Yes 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 definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one): Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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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 10, 2010 |
|--|--|
| Common Stock, par value \$0.0024 per share | 10,256,442 |

TANDY LEATHER FACTORY, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2010

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements.

Tandy Leather Factory, Inc.
Consolidated Balance Sheets

| | September 30, 2010 (unaudited) | December 31, 2009 (audited) |
|---|--------------------------------------|-----------------------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash | \$1,852,942 | \$7,891,962 |
| Short-term investments, including certificates of deposit | 1,646,593 | 5,017,000 |
| Accounts receivable-trade, net of allowance for doubtful accounts of \$148,000 and \$136,000 in 2010 and 2009, respectively | 1,443,317 | 1,202,811 |
| Inventory | 20,823,503 | 16,865,826 |
| Deferred income taxes | 302,370 | 271,481 |
| Other current assets | 2,548,044 | 791,884 |
| Total current assets | 28,616,769 | 32,040,964 |
| PROPERTY AND EQUIPMENT, at cost | 14,568,769 | 15,111,497 |
| Less accumulated depreciation and amortization | (4,611,158) | (5,431,776) |
| | 9,957,611 | 9,679,721 |
| GOODWILL | 986,206 | 983,823 |
| OTHER INTANGIBLES, net of accumulated amortization of \$464,000 and \$418,000 in 2010 and 2009, respectively | 262,991 | 307,802 |
| OTHER assets | 320,443 | 314,921 |
| | \$40,144,020 | \$43,327,231 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable-trade | \$2,567,209 | \$1,185,032 |
| Accrued expenses and other liabilities | 4,827,027 | 3,988,144 |
| Income taxes payable | 20,521 | 399,536 |
| Current maturities of long-term debt | 202,500 | 202,500 |
| Total current liabilities | 7,617,257 | 5,775,212 |
| DEFERRED INCOME TAXES | 654,918 | 682,364 |
| LONG-TERM DEBT, net of current maturities | 3,358,125 | 3,510,000 |
| COMMITMENTS AND CONTINGENCIES | - | - |
| STOCKHOLDERS' EQUITY: | | |

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| | | |
|--|--------------|--------------|
| 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; 11,150,065 and 11,021,951 shares issued at 2010 and 2009; 10,256,442 and 10,130,628 shares outstanding at 2010 and 2009, | 26,760 | 26,453 |
| Paid-in capital | 5,684,485 | 5,491,736 |
| Retained earnings | 24,872,206 | 29,959,910 |
| Treasury stock (893,623 and 891,323 shares at cost at 2010 and 2009) | (2,461,068) | (2,452,649) |
| Accumulated other comprehensive income | 391,337 | 334,205 |
| Total stockholders' equity | 28,513,720 | 33,359,655 |
| | \$40,144,020 | \$43,327,231 |

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, 2010 and 2009

| | THREE MONTHS | | NINE MONTHS | |
|---|--------------|--------------|--------------|--------------|
| | 2010 | 2009 | 2010 | 2009 |
| NET SALES | \$13,640,193 | \$12,663,604 | \$42,579,553 | \$38,893,197 |
| COST OF SALES | 5,457,668 | 5,104,455 | 16,705,466 | 15,917,561 |
| Gross profit | 8,182,525 | 7,559,149 | 25,874,087 | 22,975,636 |
| OPERATING EXPENSES | 7,106,669 | 6,695,483 | 21,817,552 | 20,006,667 |
| INCOME FROM CONTINUING OPERATIONS | 1,075,856 | 863,666 | 4,056,535 | 2,968,969 |
| OTHER INCOME (EXPENSE): | | | | |
| Interest expense | (67,565) | (68,896) | (198,784) | (229,383) |
| Other, net | 77,887 | (43,818) | 161,095 | 175,872 |
| Total other income (expense) | 10,322 | (112,714) | (37,689) | (53,511) |
| INCOME FROM CONTINUING OPERATIONS BEFORE INCOME TAXES | 1,086,178 | 750,952 | 4,018,846 | 2,915,458 |
| PROVISION FOR INCOME TAXES | 493,532 | 199,809 | 1,417,513 | 955,159 |
| NET INCOME FROM CONTINUING OPERATIONS | 592,646 | 551,143 | 2,601,333 | 1,960,299 |
| INCOME FROM DISCONTINUED OPERATIONS, NET OF TAX | 1,259 | 1,822 | 1,795 | 51,834 |
| NET INCOME | \$593,905 | \$552,965 | \$2,603,128 | \$2,012,133 |
| NET INCOME FROM CONTINUING OPERATIONS PER COMMON SHARE: | | | | |
| Basic | \$0.06 | \$0.05 | \$0.26 | \$0.19 |
| Diluted | \$0.06 | \$0.05 | \$0.25 | \$0.19 |
| NET INCOME FROM DISCONTINUED OPERATIONS PER COMMON SHARE: | | | | |
| Basic | \$0.00 | \$0.00 | \$0.00 | \$0.00 |

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| | | | | |
|--|------------|------------|------------|------------|
| Diluted | \$0.00 | \$0.00 | \$0.00 | \$0.00 |
| NET INCOME PER COMMON SHARE: | | | | |
| Basic | \$0.06 | \$0.05 | \$0.26 | \$0.19 |
| Diluted | \$0.06 | \$0.05 | \$0.25 | \$0.19 |
| Weighted Average Number of Shares Outstanding: | | | | |
| Basic | 10,256,442 | 10,387,462 | 10,195,868 | 10,575,904 |
| Diluted | 10,257,743 | 10,457,318 | 10,236,919 | 10,636,090 |

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, 2010 and 2009

| | 2010 | 2009 |
|--|-------------|-------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$2,603,128 | \$2,012,133 |
| Income from discontinued operations | 1,795 | 51,834 |
| | 2,601,333 | 1,960,299 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation & amortization | 713,366 | 852,386 |
| Loss on disposal or abandonment of assets | 11,584 | 21,520 |
| Non-cash stock-based compensation | 22,790 | 2,540 |
| Deferred income taxes | (59,006) | 68,326 |
| Other | 53,382 | 284,258 |
| Net changes in assets and liabilities: | | |
| Accounts receivable-trade, net | (246,414) | (512,476) |
| Inventory | (3,957,677) | (971,190) |
| Income taxes | (346,935) | (442,750) |
| Other current assets | (1,756,160) | (265,960) |
| Accounts payable | 1,382,177 | 465,726 |
| Accrued expenses and other liabilities | 838,883 | 224,115 |
| Total adjustments | (3,344,010) | (273,505) |
| Net cash provided by (used in) continuing operating activities | (742,677) | 1,686,794 |
| Cash provided by (used in) discontinued operating activities | (23,706) | 41,115 |
| Net cash provided by (used in) operating activities | (766,383) | 1,727,909 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of property and equipment | (963,222) | (731,763) |
| Purchase of certificates of deposit | (2,572,593) | (7,526,000) |
| Proceeds from maturities or sales of certificates of deposit | 5,943,000 | 5,128,000 |
| Proceeds from sale of assets | 6,560 | 2,090 |
| Decrease (increase) in other assets | (5,522) | 204 |
| Net cash provided by (used in) investing activities | 2,408,233 | (3,127,469) |
| Cash provided by discontinued investing activities | - | - |
| Net cash provided by (used in) investing activities | 2,408,233 | (3,127,469) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Payments on long-term debt and notes payable | (151,875) | (151,875) |
| Payments on capital lease obligations | - | (593,949) |
| Payment of dividend | (7,690,832) | - |
| Repurchase of common stock (treasury stock) | (8,419) | (1,492,375) |
| Proceeds from issuance of common stock | 170,266 | 24,818 |

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| | | |
|--|--------------------|--------------------|
| Net cash used in financing activities | (7,680,860) | (2,213,381) |
| Cash provided by discontinued financing activities | - | - |
| Net cash used in financing activities | (7,680,860) | (2,213,381) |
| NET CHANGE IN CASH | (6,039,020) | (3,612,941) |
| CASH, beginning of period | 7,891,962 | 7,810,298 |
| CASH, end of period | \$1,852,942 | \$4,197,357 |

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

| | | |
|---|-----------|-----------|
| Interest paid during the period | \$198,784 | \$229,879 |
| Income taxes paid during the period, net of (refunds) | 1,808,619 | 1,304,838 |

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, 2010 and 2009

| | Number of Shares | Par Value | Paid-in Capital | Treasury Stock | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total | Comprehensive Income (Loss) |
|--|---------------------|--------------|--------------------|-------------------|----------------------|--|--------------|--------------------------------|
| BALANCE, December 31, 2008 | 10,664,555 | \$26,388 | \$5,464,443 | \$(828,385) | \$26,641,853 | \$(39,537) | \$31,264,762 | |
| Shares issued - stock options exercised | 27,000 | 65 | 24,753 | - | - | - | 24,818 | |
| Purchase of treasury stock (525,227) | | - | - | (1,492,375) | - | - | (1,492,375) | |
| Stock-based compensation | - | - | 2,540 | - | - | - | 2,540 | |
| Net income | - | - | - | - | 2,012,133 | - | 2,012,133 | \$2,012,133 |
| Translation adjustment | - | - | - | - | - | 314,916 | 314,916 | 314,916 |
| BALANCE, September 30, 2009 | 10,166,328 | \$26,453 | \$5,491,736 | \$(2,320,760) | \$28,653,986 | \$275,379 | \$32,126,794 | |
| Comprehensive income for the nine months ended September 30, 2009 | | | | | | | | \$2,327,049 |
| | 10,130,628 | \$26,453 | \$5,491,736 | \$(2,452,649) | \$29,959,910 | \$334,205 | \$33,359,655 | |
| BALANCE, December 31, | | | | | | | | |

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2009

Shares
issued

| | | | | | | | | |
|-------------------------|-----|---------|---|---|---|---|---------|--|
| - | | | | | | | | |
| stock options exercised | 307 | 169,959 | - | - | - | - | 170,266 | |

Purchase
of
treasury
stock

| | | | | | | | | |
|---------|---|---|---------|---|---|---|---------|--|
| (2,300) | - | - | (8,419) | - | - | - | (8,419) | |
|---------|---|---|---------|---|---|---|---------|--|

Stock-based
compensation

| | | | | | | | | |
|---|---|--------|---|---|---|---|--------|--|
| - | - | 22,790 | - | - | - | - | 22,790 | |
|---|---|--------|---|---|---|---|--------|--|

Net income

| | | | | | | | |
|---|---|---|---|-----------|---|-----------|-------------|
| - | - | - | - | 2,603,128 | - | 2,603,128 | \$2,603,128 |
|---|---|---|---|-----------|---|-----------|-------------|

Cash

| | | | | | | | |
|----------|---|---|---|-------------|---|-------------|--|
| Dividend | - | - | - | (7,690,832) | - | (7,690,832) | |
|----------|---|---|---|-------------|---|-------------|--|

Translation
adjustment

| | | | | | | | |
|---|---|---|---|---|--------|--------|--------|
| - | - | - | - | - | 57,132 | 57,132 | 57,132 |
|---|---|---|---|---|--------|--------|--------|

BALANCE,

September

| | | | | | | | | |
|-----|------|------------|----------|-------------|---------------|--------------|-----------|--------------|
| 30, | 2010 | 10,256,442 | \$26,760 | \$5,684,485 | \$(2,461,068) | \$24,872,206 | \$391,337 | \$28,513,720 |
|-----|------|------------|----------|-------------|---------------|--------------|-----------|--------------|

Comprehensive income for the nine months ended

| | | | | | | | |
|--------------------|--|--|--|--|--|--|-------------|
| September 30, 2010 | | | | | | | \$2,660,260 |
|--------------------|--|--|--|--|--|--|-------------|

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, 2010 and December 31, 2009, and its results of operations and cash flows for the three and/or nine-month periods ended September 30, 2010 and 2009, respectively. Operating results for the three and nine-month periods ended September 30, 2010 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2010. 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, 2009.

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, 2010 | December 31, 2009 |
| Inventory on hand: | | |
| Finished goods held for sale | \$18,414,812 | \$14,861,855 |
| Raw materials and work in process | 395,786 | 609,002 |
| Inventory in transit | 2,012,905 | 1,394,969 |
| | \$20,823,503 | \$16,865,826 |

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 tested 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, 2009, 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

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respective goodwill balances. No indicators of impairment were identified during the first nine months of 2010.

A summary of changes in our goodwill for the nine-month periods ended September 30, 2010 and 2009 is as follows:

| | Leather Factory | Tandy Leather | Total |
|------------------------------|-----------------|---------------|-----------|
| Balance, December 31, 2008 | \$583,249 | \$383,406 | \$966,655 |
| Acquisitions and adjustments | - | - | - |
| Foreign exchange gain (loss) | 14,515 | - | 14,515 |
| Impairments | - | - | - |
| Balance, September 30, 2009 | \$597,764 | \$383,406 | \$981,170 |

| | Leather Factory | Tandy Leather | Total |
|------------------------------|-----------------|---------------|-----------|
| Balance, December 31, 2009 | \$600,417 | \$383,406 | \$983,823 |
| Acquisitions and adjustments | - | - | - |
| Foreign exchange gain (loss) | 2,383 | - | 2,383 |
| Impairments | - | - | - |
| Balance, September 30, 2010 | \$602,800 | \$383,406 | \$986,206 |

Other intangibles consist of the following:

| | As of September 30, 2010 | | | As of December 31, 2009 | | |
|------------------------|--------------------------|------------------------------|-----------|-------------------------|------------------------------|-----------|
| | Gross | Accumulated Net Amortization | | Gross | Accumulated Net Amortization | |
| Trademarks, | \$544,369 | \$382,833 | \$161,536 | \$544,369 | \$356,067 | \$188,302 |
| Copyrights | | | | | | |
| Non-Compete Agreements | 182,182 | 80,727 | 101,455 | 181,636 | 62,136 | 119,500 |
| | \$726,551 | \$463,560 | \$262,991 | \$726,005 | \$418,203 | \$307,802 |

We recorded amortization expense of \$45,255 during the first nine months of 2010, compared to \$34,587 in the same period of 2009. All of our intangible assets are subject to amortization in accordance with U.S. GAAP. 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 |
|------|------------------------|---------------------|----------|
| 2010 | \$45,440 | \$30,337 | \$75,777 |
| 2011 | 13,263 | 30,337 | 43,600 |
| 2012 | 6,177 | 30,337 | 36,514 |
| 2013 | - | 30,337 | 30,337 |
| 2014 | - | 30,337 | 30,337 |

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.

Subsequent Events. Management has evaluated subsequent events after the balance sheet date through November 15, 2010 for appropriate accounting and disclosure. See Note 8 for additional information regarding subsequent events.

Recent Accounting Pronouncements. In January 2010, the Financial Accounting Standards Board, or FASB, issued guidance titled "Improving Disclosures About Fair Value Measurements" that amends existing disclosure requirements by adding required disclosures about items transferring into and out of levels 1 and 2 in the fair value hierarchy; adding separate disclosures about purchase, sales, issuances, and settlements relative to level 3 measurements; and clarifying, among other things, the existing fair value disclosures about the level of disaggregation. Except for the separate level 3 disclosures, this guidance was effective for financial statements issued for interim or fiscal years beginning after December 15, 2009 and our adoption of it on January 1, 2010 did not have a material impact on our financial condition or results of operations. The rest of the guidance is effective for financial statements issued for interim or fiscal years beginning after December 15, 2010. Since these are disclosure requirements only, our adoption will not have a material impact on our financial condition or results of operations.

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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 September 30, 2010 and December 31, 2009 consisted of certificates of deposit. The contractual maturities of the certificates of deposit as of September 30, 2010 are shown below.

| | |
|--------------------------------------|-------------|
| Due within one year | \$1,310,593 |
| Due between one and five years | 336,000 |
| Due between five and ten years | - |
| Due between ten and fifteen years | - |
| Due between fifteen and twenty years | - |
| | \$1,646,593 |

We measure fair value as an exit price, which is the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As a basis for considering such assumptions, accounting standards establish a three-tier value hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

Level 1 – observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 – include other inputs that are directly or indirectly observable in the marketplace.

Level 3 – unobservable inputs which are supported by little or no market activity.

Classification of the financial asset or liability within the hierarchy is determined based on the lowest level input that is significant to the fair value measurement. We classify our certificates of deposit as level 2 assets and have maintained consistency in valuation techniques during the period ended September 30, 2010.

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 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.

On July 15, 2010, we entered into a Credit Agreement and Line of Credit Note with Comerica Bank, pursuant to which the bank agreed to provide us with a revolving credit facility of up to \$2,500,000. The revolver bears interest at LIBOR plus 2.0% and matures on June 29, 2011. At September 30, 2010, no borrowings had occurred and no amounts were outstanding under the above agreement.

The terms of the Credit Agreement contain various covenants which, among other things, limit further indebtedness to \$1 million and from entering into any new business or making material changes in any of our business objectives, purposes or operations. We also have an affirmative duty to disclose any covenant violation to the lender.

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At September 30, 2010 and December 31, 2009, the amount outstanding under the above agreement consisted of the following:

| | September 30, 2010 | December 31, 2009 |
|--|-----------------------|----------------------|
| 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; matures April 30, 2018 | \$ 3,560,625 | \$3,712,500 |
| Credit Agreement with Comerica Bank – unsecured; payable as follows: | | |
| Master Revolving Note dated June 30, 2010 in the maximum principal amount of \$2,500,000 – interest due monthly as LIBOR plus 2%; matures June 29, 2011 | - | - |
| | 3,560,625 | 3,712,500 |
| Less - Current maturities | (202,500) | (202,500) |
| | \$3,358,125 | \$3,510,000 |

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. 9,000 and 3,000 options were awarded to directors in the second and third quarters of 2010, respectively. These options vest and become exercisable six months from the option grant date. Given the short vesting period, we recognize compensation expense fully at the time of grant. 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 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 \$4,402 and \$0 for each of the quarters ended September 30, 2010 and 2009, respectively, and \$22,790 and \$2,540 for each of the nine month periods ended September 30, 2010 and 2009, respectively, as a component of operating expenses.

During the nine months ended September 30, 2010 and 2009, 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, 2009 | \$2.16 | 224,700 | | |
| Granted | - | - | | |
| Cancelled | - | - | | |
| Exercised | 0.92 | 27,000 | | |
| Outstanding, September 30, 2009 | \$2.33 | 197,700 | 2.55 | \$246,088 |
| | \$2.33 | 197,700 | 2.55 | \$246,088 |

Exercisable, September 30,
2009

| | | | | |
|------------------------------------|--------|---------|------|-----------|
| Outstanding, January 1, 2010 | \$2.33 | 197,700 | | |
| Granted | 5.078 | 12,000 | | |
| Cancelled | - | - | | |
| Exercised | 1.647 | 136,700 | | |
| Outstanding, September 30, 2010 | \$4.34 | 73,000 | 4.21 | \$154,275 |
| Exercisable, September 30, 2010 | \$4.19 | 61,000 | 3.13 | \$131,485 |

Other information pertaining to option activity during the nine month periods ended September 30, 2010 and 2009 is as follows:

| | September 30, 2010 | September 30, 2009 |
|---|--------------------|--------------------|
| Weighted average grant-date fair value of stock options granted | \$1.90 | N/A |
| Total fair value of stock options vested | \$22,790 | \$2,540 |
| Total intrinsic value of stock options exercised | \$114,603 | \$1,035 |

As of September 30, 2010 and 2009, there was no unrecognized compensation cost related to nonvested 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, 2010 and 2009:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|------------|------------------------------------|-------------|
| | 2010 | 2009 | 2010 | 2009 |
| Numerator: | | | | |
| Net income | \$593,905 | \$552,965 | \$2,603,128 | \$2,012,133 |
| Numerator for basic and diluted earnings per share | 593,905 | 552,965 | 2,603,128 | 2,012,133 |
| Denominator: | | | | |
| Weighted-average shares outstanding-basic | 10,256,442 | 10,387,462 | 10,195,868 | 10,575,904 |
| Effect of dilutive securities: | | | | |
| Stock options | 1,301 | 69,856 | 41,051 | 60,186 |
| Dilutive potential common shares | 1,301 | 69,856 | 41,051 | 60,186 |
| Denominator for diluted earnings per share-weighted-average shares | 10,257,743 | 10,457,318 | 10,236,919 | 10,636,090 |
| Basic earnings per share | \$0.06 | \$0.05 | \$0.26 | \$0.19 |
| Diluted earnings per share | \$0.06 | \$0.05 | \$0.25 | \$0.19 |

The net effect of converting stock options to purchase 10,000 and 128,700 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 ended September 30, 2010 and 2009, respectively.

6. CASH DIVIDEND

In May 2010, our Board of Directors authorized a \$0.75 per share special one-time cash dividend that was paid to shareholders of record at the close of business on June 3, 2010. We released the funds used to pay for the special one-time cash dividend on July 1, 2010 and the dividend, totaling \$7.7 million, was paid to shareholders on July 5, 2010. 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. We did not make any dividend payments during 2009.

7. SEGMENT INFORMATION

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

- Wholesale Leathercraft, which consists of a chain of wholesale stores operating under the name, The Leather Factory, located in North America;
- Retail Leathercraft, which consists of a chain of retail stores operating under the name, Tandy Leather Company, located in North America; and
- International Leathercraft, consists of one combination wholesale/retail store located in Northampton, United Kingdom.

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 | International Leathercraft | Discontinued Operations | Total |
|--|---------------------------|------------------------|-------------------------------|----------------------------|---------------|
| For the quarter ended September 30, 2010 | | | | | |
| Net sales | \$6,012,932 | \$7,212,443 | \$414,818 | | \$13,640,193 |
| Gross profit | 3,699,403 | 4,238,791 | 244,331 | | 8,182,525 |
| Operating earnings | 510,256 | 518,718 | 46,882 | | 1,075,856 |
| Interest (expense) | (67,565) | - | - | | (67,565) |
| Other income (expense), net | 60,634 | (356) | 17,609 | | 77,887 |
| Income before income taxes | 503,325 | 518,362 | 64,491 | | 1,086,178 |
| Depreciation and amortization | 204,097 | 33,294 | 4,565 | | 241,956 |
| Fixed asset additions | 205,409 | 22,985 | - | | 228,394 |
| Total assets | \$33,282,964 | \$6,328,371 | \$532,685 | | -\$40,144,020 |

| | | | | | |
|--|--------------|-------------|-------------|-----------|--------------|
| For the quarter ended September 30, 2009 | | | | | |
| Net sales | \$5,877,153 | \$6,444,179 | \$342,272 | | \$12,663,604 |
| Gross profit | 3,377,776 | 3,951,290 | 230,083 | | 7,559,149 |
| Operating earnings | 338,567 | 472,653 | 52,446 | | 863,666 |
| Interest expense | (68,896) | - | - | | (68,896) |
| Other income (expense), net | (4,694) | (2,822) | (36,302) | | (43,818) |
| Income before income taxes | 264,977 | 469,831 | 16,144 | | 750,952 |
| Depreciation and amortization | 253,247 | 34,677 | 3,627 | | 291,551 |
| Fixed asset additions | 228,397 | 60,577 | 387 | | 289,361 |
| Total assets | \$34,344,104 | \$5,740,148 | \$1,381,151 | \$120,085 | \$41,585,488 |

| | | | | | |
|--|--------------|--------------|-------------|--|---------------|
| For the nine months ended September 30, 2010 | | | | | |
| Net sales | \$18,849,015 | \$22,535,418 | \$1,195,120 | | \$42,579,553 |
| Gross profit | 11,491,749 | 13,649,194 | 733,144 | | 25,874,087 |
| Operating earnings | 1,667,718 | 2,210,932 | 177,885 | | 4,056,535 |
| Interest (expense) | (198,784) | - | - | | (198,784) |
| Other income (expense), net | 157,590 | (880) | 4,385 | | 161,095 |
| Income before income taxes | 1,626,524 | 2,210,052 | 182,270 | | 4,018,846 |
| Depreciation and amortization | 603,712 | 98,329 | 11,325 | | 713,366 |
| Fixed asset additions | 902,858 | 60,364 | - | | 963,222 |
| Total assets | \$33,282,964 | \$6,328,371 | \$532,685 | | -\$40,144,020 |

| | | | | | |
|--|--------------|--------------|-----------|--|--------------|
| For the nine months ended September 30, 2009 | | | | | |
| Net sales | \$18,276,275 | \$19,673,926 | \$942,996 | | \$38,893,197 |
| Gross profit | 10,448,620 | 11,928,023 | 598,993 | | 22,975,636 |
| Operating earnings | 1,193,341 | 1,669,128 | 106,500 | | 2,968,969 |
| Interest expense | (229,383) | - | - | | (229,383) |
| Other income (expense), net | 81,940 | (1,932) | 95,864 | | 175,872 |
| Income before income taxes | 1,045,898 | 1,667,196 | 202,364 | | 2,915,458 |

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| | | | | |
|-------------------------------|--------------|-------------|-------------|---------------|
| Depreciation and amortization | 750,645 | 91,549 | 10,192 | 852,386 |
| Fixed asset additions | 614,322 | 117,054 | 387 | 731,763 |
| Total assets | \$34,344,104 | \$5,740,148 | \$1,381,151 | \$120,085,488 |

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Net sales for geographic areas for the three and nine months ended September 30, 2010 and 2009 were as follows:

| Three months ended September 30, | 2010 | 2009 |
|----------------------------------|--------------|--------------|
| United States | \$11,681,130 | \$10,888,476 |
| Canada | 1,300,564 | 1,097,646 |
| All other countries | 658,499 | 677,482 |
| | \$13,640,193 | \$12,663,604 |
| Nine months ended September 30, | 2010 | 2009 |
| United States | \$36,865,020 | \$33,804,043 |
| Canada | 4,022,287 | 3,228,780 |
| All other countries | 1,692,246 | 1,860,374 |
| | \$42,579,553 | \$38,893,197 |

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, 2010 or 2009. We do not have any significant long-lived assets outside of the United States.

8. SUBSEQUENT EVENT – STORE CLOSING

On October 15, 2010, we announced the closing of Mid-Continent Leather Sales, a wholesale store located in Coweta, Oklahoma, due to its unsatisfactory sales and earnings performance. In the fourth quarter, we anticipate incurring the following one-time expenses associated with the store closing, which will be included in operating expenses:

| | |
|-------------------------|----------|
| Lease termination costs | \$30,000 |
| Non-compete agreement | 20,000 |
| | \$50,000 |

In previous announcements regarding the store-closing expenses to be incurred in the fourth quarter, we included the write-off of some goodwill as a result of the store closing. However, after further analysis, we do not expect our goodwill to be impaired as a result of this store closing and therefore, will not incur that charge.

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 NASDAQ under the symbol “TLF.” We operate our business in three segments: Wholesale Leathercraft, which operates wholesale stores in North America under the trade name, The Leather Factory, Retail Leathercraft, which operates retail stores in North America under the trade name, Tandy Leather Company, and International Leathercraft, which operates retail and wholesale stores outside of North America under the trade name, Tandy Leather Factory. See Note 7 to the Consolidated Financial Statements for additional information concerning our segments, as well as our foreign operations.

Our Wholesale Leathercraft segment operates 29 company-owned wholesale stores in 19 states and three Canadian provinces. These stores are engaged in the wholesale distribution of leather and related items, including leatherworking tools, buckles and belt adornments, leather dyes and finishes, saddle and tack hardware, and

do-it-yourself kits, to retailers, manufacturers, and end users. Our Wholesale Leathercraft segment also includes our National Account sales group, whose only customers are national craft chains.

Our Retail Leathercraft segment operates company-owned Tandy Leather Company retail stores in 35 states and six 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, 2010, we were operating 76 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, operates as a combination retail and wholesale store.

Critical Accounting Policies

A description of our critical accounting policies appears in Item 7 "Management's Discussions and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2009.

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. There are certain important risks that could cause results to differ materially from those anticipated by some of the forward-looking statements. Some, but not all, of the important risks, including those described below, could cause actual results to differ materially from those suggested by the forward-looking statements. Please refer also to our Annual Report on Form 10-K for fiscal year ended December 31, 2009 for additional information concerning these and other uncertainties that could negatively impact the Company.

Ø We believe that a 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.

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 any incurred cost increases on to us. We are unsure how much of this increase 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.

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Results of Operations

Three Months Ended September 30, 2010 and 2009

The following tables present selected financial data of each of our three segments for the quarters ended September 30, 2010 and 2009.

| | Quarter Ended September 30, 2010 | | Quarter Ended September 30, 2009 | |
|----------------------------|----------------------------------|------------------|----------------------------------|------------------|
| | Sales | Operating Income | Sales | Operating Income |
| Wholesale Leathercraft | \$6,012,932 | \$510,256 | \$5,877,153 | \$338,567 |
| Retail Leathercraft | 7,212,443 | 518,718 | 6,444,179 | 472,653 |
| International Leathercraft | 414,818 | 46,882 | 342,272 | 52,446 |
| Total Operations | \$13,640,193 | \$1,075,856 | \$12,663,604 | \$863,666 |

Consolidated net sales for the quarter ended September 30, 2010 increased 977,000 or 8%, compared to the same period in 2009. All three segments contributed to the sales increase. Operating income on a consolidated basis for the quarter ended September 30, 2010 was up 25% or \$212,000 over the third quarter of 2009.

The following table shows in comparative form our consolidated net income for the third quarters of 2010 and 2009:

| | 2010 | 2009 | % Change |
|------------|-----------|-----------|----------|
| Net income | \$593,905 | \$552,965 | 7.4% |

Wholesale Leathercraft

Our Wholesale Leathercraft operation consists of 29 wholesale stores and our National Account sales group. The following table presents the combined sales mix by customer categories for the quarters ended September 30, 2010 and 2009:

| Customer Group | Quarter ended | |
|---|--------------------|--------------------|
| | September 30, 2010 | September 30, 2009 |
| RETAIL (end users, consumers, individuals) | 25% | 22% |
| INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.) | 6% | 7% |
| WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.) | 43% | 45% |
| MANUFACTURERS | 9% | 9% |
| NATIONAL ACCOUNTS | 17% | 17% |
| | 100% | 100% |

Net sales were up 2% for the third quarter of 2010 as follows:

| | Quarter Ended September 30, 2010 | Quarter Ended September 30, 2009 | \$ change | % change |
|------------------------|----------------------------------|----------------------------------|-----------|----------|
| Same store sales (30) | \$5,193,313 | \$5,056,473 | \$136,840 | 2.7% |
| National account group | 819,619 | 820,680 | (1,061) | (0.0)% |
| | \$6,012,932 | \$5,877,153 | \$135,779 | 2.3% |

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Our same store sales increased 3% in the third quarter of 2010, as compared with the same period in 2009. Compared to the third quarter of 2009, sales to our Retail customers increased significantly while sales to our other customer groups all reported slight decreases. These sales trends are consistent throughout our company – that is, our retail business appears to be strengthening while our wholesale business continues to show signs of weakness. We believe the overall U.S. economy is the primary reason for these sales trends. It is our belief that our wholesale customers, which are primarily small businesses, have not recovered from what continues to be a difficult economic environment for them. Until they gain some confidence that worst is behind them economically, we expect our wholesale business to continue to lag behind retail. Sales to our national account customers were relatively consistent with that of the same quarter last year.

Operating income for Wholesale Leathercraft during the quarter ended September 30, 2010 increased by \$196,000 from the comparative 2009 quarter, an improvement of 63%, due to higher gross profit margins and sales growing faster than expenses. Operating expenses as a percentage of sales were 53%, up \$125,000 from the third quarter of 2009. Compared to last year's third quarter, employee compensation and benefits increased \$146,000, legal & professional fees increased \$32,000, and travel expenses increased \$44,000. These increases were partially offset with decreases in supplies (\$48,000), advertising and marketing costs (\$44,000), and miscellaneous administrative expenses (\$20,000).

Retail Leathercraft

Our Retail Leathercraft operation consists of 76 Tandy Leather retail stores at September 30, 2010, compared to 75 stores at September 30, 2009. Net sales were up 12% for the third quarter of 2010 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 | Quarter Ended September 30, 2010 | Quarter Ended September 30, 2009 | \$ Incr (Decr) | % Incr (Decr) |
|-----------------------------|----------|--|--|-------------------|------------------|
| Same (existing) store sales | 75 | \$7,163,786 | \$6,444,179 | \$719,607 | 11.2% |
| New store sales | 1 | 48,657 | - | 48,657 | N/A |
| Total sales | 75 | \$7,212,443 | \$6,444,179 | \$768,264 | 11.9% |

The following table presents sales mix by customer categories for the quarters ended September 30, 2010 and 2009 for our Retail Leathercraft operation:

| Customer Group | Quarter Ended | |
|---|-----------------------|-----------------------|
| | September 30, 2010 | September 30, 2009 |
| RETAIL (end users, consumers, individuals) | 63% | 62% |
| INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.) | 4% | 7% |
| WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.) | 32% | 30% |
| NATIONAL ACCOUNTS | - | - |
| MANUFACTURERS | 1% | 1% |
| | 100% | 100% |

Sales to our Retail and Wholesale customer groups in the third quarter of 2010 increased compared to the third quarter of 2009, while sales to our Institution and 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 struggling U.S. economy is the primary reason for these sales trends. That is, the retail

customer is slowly gaining confidence in their ability to spend discretionary dollars. The wholesale customer, however, appears to be questioning his ability to keep his doors open until the economy has recovered. As a result, he is extremely cautious in his purchases. The retail stores averaged approximately \$31,000 in sales per store per month for the third quarter of 2010.

Operating income in the third quarter of 2010 increased \$46,000 from the comparative 2009 quarter, an increase of 10%. Our gross margin declined from 61.3% to 58.8% due to an aggressive marketing campaign during the quarter which featured several low margin items for sale. Operating expenses as a percentage of sales decreased from 53.9% to 51.6% as sales grew at a faster rate than expenses during the quarter. Compared to last year's third quarter, employee compensation and benefits increased \$112,000, credit card fees increased \$14,000, supplies increased \$15,000, store lease expenses increased \$32,000, and customer freight costs increased \$30,000.

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International Leathercraft

Sales totaled \$415,000 for the third quarter of 2010, compared to \$342,000 in the third quarter of 2009, an increase of 21%. Gross profit margin fell from 67.2% in last year's third quarter to 58.9% in the current quarter. The decline is due primarily to the fluctuation in inventory value between the U.S. dollar and the British pound. Operating expenses totaled \$197,000, an increase of \$20,000 over the third quarter of 2009. The largest expense contributors were employee compensation, advertising, shipping to customers, and rent.

Other Income (Expense)

We paid \$67,000 in interest expense in the third quarter of 2010 on our bank debt, which is related to our building purchase, compared to \$69,000 in interest expense in the third quarter last year. We earned \$10,000 in interest income during the third quarter of 2010, a \$32,000 decrease over last year's third quarter interest income earned of \$42,000, due to the reduction in our cash. We recorded \$6,000 in income during the third quarter of 2010 related to currency fluctuations from our Canadian and UK operations. Comparatively, in the third quarter of 2009, we recorded an expense of \$115,000 for currency fluctuations.

Nine Months Ended September 30, 2010 and 2009

The following table presents selected financial data of each of our three segments for the nine months ended September 30, 2010 and 2009:

| | Nine Months Ended September 30, 2010 | | Nine Months Ended September 30, 2009 | |
|----------------------------|--------------------------------------|--------------------|--------------------------------------|--------------------|
| | Sales | Operating Income | Sales | Operating Income |
| Wholesale Leathercraft | \$18,849,015 | \$1,667,718 | \$18,276,275 | \$1,193,341 |
| Retail Leathercraft | 22,535,418 | 2,210,932 | 19,673,926 | 1,669,128 |
| International Leathercraft | 1,195,120 | 177,885 | 942,996 | 106,500 |
| Total Operations | \$42,579,553 | \$4,056,535 | \$38,893,197 | \$2,968,969 |

Consolidated net sales for the nine months ended September 30, 2010 were up 9% compared to the first nine months of 2009. All three segments contributed to the sales increase. Operating income on a consolidated basis for the nine months ended September 30, 2010 increased 36% or \$1.1 million compared to the first nine months of 2009.

The following table shows in comparative form our consolidated net income for the first three quarters of 2010 and 2009:

| | 2010 | 2009 | % change |
|------------|-------------|-------------|----------|
| Net income | \$2,603,128 | \$2,012,133 | 29.4% |

Wholesale Leathercraft

Net sales increased 3.1%, or \$573,000, for the first three quarters of 2010 as follows:

| | Nine Months Ended September 30, 2010 | Nine Months Ended September 30, 2009 | \$ Incr (Decr) | % Incr (Decr) |
|--|--------------------------------------|--------------------------------------|----------------|---------------|
| | | | | |

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| | | | | |
|------------------------|--------------|--------------|-----------|--------|
| Same store sales (30) | \$16,544,718 | \$15,798,472 | 746,246 | 4.7% |
| National account group | 2,304,297 | 2,477,803 | (173,506) | (7.0%) |
| | \$18,849,015 | \$18,276,275 | 572,740 | 3.1% |

The following table presents the combined sales mix by customer categories for the nine months ended September 30, 2010 and 2009:

| Customer Group | Nine Months Ended | |
|---|-----------------------|-----------------------|
| | September 30, 2010 | September 30, 2009 |
| RETAIL (end users, consumers, individuals) | 28% | 27% |
| INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.) | 7% | 7% |
| WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.) | 42% | 42% |
| MANUFACTURERS | 8% | 8% |
| NATIONAL ACCOUNTS | 15% | 16% |
| | 100% | 100% |

Operating income for Wholesale Leathercraft for the first three quarters of 2010 increased by \$474,000 from the comparative 2009 period, an improvement of 40%, due to the improvement in gross profit margin, offset by the increase in operating expenses. Compared to the first nine months of 2009, operating expenses increased \$569,000 for the first three quarters of 2010, or 6%, increasing from 50.7% of sales for the first nine months of 2009 to 52.1% of sales for the first nine months of 2010.

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Retail Leathercraft

Net sales were up 15% for the first three quarters of 2010 over the same period last year.

| | # Stores | Nine Months Ended September 30, 2010 | Nine Months Ended September 30, 2009 | \$ Incr (Decr) | % Incr (Decr) |
|-----------------------------|----------|---|---|-------------------|------------------|
| Same (existing) store sales | 74 | \$22,234,331 | \$19,618,466 | \$2,615,865 | 13.3% |
| New store sales | 2 | 301,087 | 55,460 | 245,627 | N/A |
| Total sales | 76 | \$22,535,418 | \$19,673,926 | \$2,861,492 | 14.5% |

The following table presents sales mix by customer categories for the nine months ended September 30, 2010 and 2009 for our Retail Leathercraft operation:

| Customer Group | Nine Months Ended | |
|---|-----------------------|-----------------------|
| | September 30, 2010 | September 30, 2009 |
| RETAIL (end users, consumers, individuals) | 63% | 63% |
| INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.) | 6% | 8% |
| WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.) | 30% | 29% |
| NATIONAL ACCOUNTS | - | - |
| MANUFACTURERS | 1% | - |
| | 100% | 100% |

The retail stores averaged approximately \$33,000 in sales per month for the first three quarters of 2010.

Operating income for the first nine months of 2010 increased \$542,000 from the comparative 2009 period, improving as a percentage of sales, from 8.5% in the first nine months of 2009 to 9.8% in the first nine months of 2010. Gross margin held steady at 60.6%. Operating expenses as a percentage of sales declined from 52.1% during the first three quarters of 2009 to 50.8% during the first three quarters of 2010.

International Leathercraft

Sales totaled \$1.2 million for the first nine months of 2010, an increase of 27% from sales of \$943,000 from the same period of 2009. These sales are generated from our one store located in the UK, which opened in February 2008. Gross profit margin was 61.3% for the first three quarters of 2010, a decline from the 2009 comparable period's gross profit margin of 63.5%. 2010 year-to-date operating expenses totaled \$555,000 compared to 2009 year-to-date operating expenses of \$492,000, an increase of \$63,000. Advertising, credit card fees, and shipping costs to customers accounted for the majority of the increase over the prior year. Operating income in 2010 totaled \$178,000 compared to 2009 year-to-date operating income of \$106,000, an increase of 67%, due to sales growing faster than expenses.

Other Income (Expenses)

We paid \$199,000 in interest expense in the first nine months of 2010 on our debt related to our building purchase compared to \$230,000 in interest expense in the first nine months of 2009. We earned \$67,000 in interest income in the nine months ended September 30, 2010, down from last year's interest income of \$103,000. We recorded \$68,000 in expense during the nine months ended September 30, 2010 for currency fluctuations from our Canadian and UK

operations. Comparatively, in the first three quarters of 2009, we recorded an expense of \$8,000 for currency fluctuations.

Capital Resources, Liquidity and Financial Condition

On our consolidated balance sheet, total assets decreased from \$43.3 million at year-end 2009 to \$40.1 million at September 30, 2010. The decrease in cash and short-term investments (which consists of certificates of deposit), offset by an increase in inventory and other current assets, accounted for the increase. The decrease in cash and short-term investments was primarily the result of the special, one-time dividend of \$7.7 million that was paid in July 2010. The increase in other current assets consisted of \$1.3 million in merchandise paid in advance of shipping by the vendor and \$250,000 for a three-year license renewal of our point-of-sale software. Total stockholders' equity decreased from \$33.3 million at December 31, 2009 to \$28.5 million at September 30, 2010. The decrease was also attributable to the dividend, partially offset by our 2010 earnings. Our current ratio dropped to 3.8 at September 30, 2010 from 5.6 at December 31, 2009 due to the reduction in cash held as a result of the \$7.7 million dividend paid.

Our investment in inventory increased by \$4 million at September 30, 2010 from year-end 2009. We closely manage our inventory levels to follow our sales trends. An increase in inventory is expected at this time of year as we stock for the fourth quarter and Christmas shopping season. In addition, we made several non-routine purchases of product in the third quarter which we will feature in our sales promotions during the first quarter of 2011. As a result, we expect our purchases in the next several months to decline. Inventory turnover slowed slightly for the first nine months of 2010 compared to the same period of 2009, as the year-to-date 2010 rate was 3.01 and the year-to-date 2009 rate of 3.18. Inventory turnover was 3.34 times for all of 2009. We compute our inventory turns as sales divided by average inventory. At the end of the third quarter of 2010, our total inventory on hand is approximately 20% higher than our internal targets for optimal inventory levels as a result of numerous new items added to our active product line effective October 1st. We anticipate strong customer acceptance of these new items over the coming months. We will monitor our inventory purchases for the remainder of the year relative to our sales to ensure appropriate use of our working capital.

Trade accounts receivable was \$1.4 million at September 30, 2010, up \$240,000 from \$1.2 million at year-end 2009. The average days to collect accounts for the first three quarters of 2010 were 46 days, up slightly from 44 days for the first three quarters of 2009. We have tightened our credit policy given the current economic environment and are closely monitoring our customers with open accounts to ensure collectability of the accounts.

Accounts payable increased \$1.4 million to \$2.6 million at the end of the September 2010, due to the increase of inventory purchases in the third quarter. Accrued expenses and other liabilities increased \$839,000, the majority of which is the increase in inventory in transit to us at September 30, 2010 compared to December 31, 2009.

During the first three quarters of 2010, cash flow used in operating activities was \$766,000. The increase in inventory and other current assets, offset partially by net income and the increase in accounts payable accounted for the majority of the cash used. Cash flow provided by investing activities totaled \$2.4 million, consisting of \$3.3 million in net certificate of deposit maturities, partially offset by \$963,000 in fixed asset purchases. Cash flow used by financing activities totaled \$7.7 million, which is the dividend paid.

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

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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, 2009. Our exposure to market risks has not changed significantly since December 31, 2009.

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 officers, 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, 2010. 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, 2010, 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, 2010 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.

As the following table indicates, we made no purchases of our common stock during the quarter ended September 30, 2010, as the prevailing market prices were above our maximum purchase price:

| 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 – July 31 | - | - | - | 962,000 |
| August 1 – August 31 | - | - | - | 962,000 |
| September 1 – September 30 | - | - | - | 962,000 |

| | | | | |
|-------|---|---|---|---------|
| Total | - | - | - | 962,000 |
|-------|---|---|---|---------|

- (1) Represents shares that we may purchase through a stock repurchase program permitting us to repurchase up to one million shares of our common stock at prevailing market prices not to exceed \$3.70 per share. We announced the program on December 9, 2009, such program replacing our previous stock repurchase program which permitted us, on the date of its termination, to repurchase up to 974,773 shares of our common stock at prevailing prices not to exceed \$2.85 per share. Purchases under the program commenced on December 9, 2009 and will terminate on December 10, 2010.

Item 6. Exhibits.

| Exhibit Number | Description |
|----------------|--|
| 3.1 | Certificate of Incorporation of The Leather Factory, Inc., and Certificate of Amendment to Certificate of Incorporation of The Leather Factory, Inc. filed as Exhibit 3.1 to Form 10-Q filed by Tandy Leather Factory, Inc. with the Securities and Exchange Commission on August 12, 2005 and incorporated by reference herein. |
| 3.2 | Bylaws of The Leather Factory, Inc., filed as Exhibit 3.5 to the Current Report on Form 8-K (Commission File No. 001-12368) filed by Tandy Leather Factory, Inc (f/k/a The Leather Factory, Inc.) with the Securities and Exchange Commission on July 14, 2004 and incorporated by reference herein. |
| *31.1 | 13a-14(a) or 15d-14(a) Certification by Jon Thompson, Chief Executive Officer and President. |
| *31.2 | 13a-14(a) or 15d-14(a) Certification by Shannon Greene, Chief Financial Officer and Treasurer. |
| *32.1 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

*Filed herewith.

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SIGNATURES

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

TANDY LEATHER FACTORY, INC.
(Registrant)

Date: November 15, 2010

By: /s/ Jon Thompson
Jon Thompson
Chief Executive Officer and President

Date: November 15, 2010

By: /s/ Shannon L. Greene
Shannon L. Greene
Chief Financial Officer and Treasurer (Chief Accounting
Officer)