

TANDY LEATHER FACTORY INC  
Form 10-Q  
August 14, 2012

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 June 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  
(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 such 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 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  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 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 August 10, 2012 |
|--|--|
| Common Stock, par value \$0.0024 per share | 10,156,442                               |

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TANDY LEATHER FACTORY, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2012

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## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements.

Tandy Leather Factory, Inc.  
Consolidated Balance Sheets

|   | June<br>30, 2012<br>(unaudited) | December<br>31, 2011<br>(audited) |
|---|---------------------------------|-----------------------------------|
| <b>ASSETS</b>   |                                 |                                   |
| <b>CURRENT ASSETS:</b>  |                                 |                                   |
| Cash  | \$3,816,559                     | \$10,765,591                      |
| Short-term investments, including certificates of deposit   | 85,533                          | 423,893                           |
| Accounts receivable-trade, net of allowance for doubtful accounts<br>of \$170,000 and \$81,000 in 2012 and 2011,<br>respectively        | 1,118,871                       | 1,328,579                         |
| Inventory   | 29,749,811                      | 19,940,251                        |
| Deferred income taxes   | 392,283                         | 281,251                           |
| Other current assets  | 1,564,186                       | 948,459                           |
| Total current assets  | 36,727,243                      | 33,688,024                        |
| PROPERTY AND EQUIPMENT, at cost   | 15,360,240                      | 14,999,826                        |
| Less accumulated depreciation and amortization  | (5,167,913)                     | (4,700,476)                       |
|   | 10,192,327                      | 10,299,350                        |
| GOODWILL  | 987,634                         | 987,009                           |
| OTHER INTANGIBLES, net of accumulated amortization of<br>\$562,000 and \$539,000 in 2012 and 2011, respectively                         | 165,040                         | 187,292                           |
| Other assets  | 338,039                         | 341,240                           |
|   | \$48,410,283                    | \$45,502,915                      |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                                 |                                   |
| <b>CURRENT LIABILITIES:</b>   |                                 |                                   |
| Accounts payable-trade  | \$3,018,362                     | \$1,622,697                       |
| Accrued expenses and other liabilities  | 6,078,453                       | 4,641,191                         |
| Income taxes payable  | 334,240                         | 638,897                           |
| Current maturities of long-term debt  | 202,500                         | 202,500                           |
| Total current liabilities   | 9,633,555                       | 7,105,285                         |
| DEFERRED INCOME TAXES   | 851,931                         | 858,829                           |
| LONG-TERM DEBT, net of current maturities   | 3,003,750                       | 3,105,000                         |
| <b>COMMITMENTS AND CONTINGENCIES</b>  |                                 |                                   |
| <b>STOCKHOLDERS' EQUITY:</b>  |                                 |                                   |
| Preferred stock, \$0.10 par value; 20,000,000 shares authorized;<br>none issued or outstanding; attributes to be determined on issuance | -                               | -                                 |

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|   |              |              |
|---|--------------|--------------|
| Common stock, \$0.0024 par value; 25,000,000 shares authorized;<br>11,150,065 shares issued at 2012 and 2011;<br>10,156,442 shares outstanding at 2012 and 2011 | 26,760       | 26,760       |
| Paid-in capital   | 5,746,543    | 5,736,543    |
| Retained earnings   | 31,759,549   | 31,181,936   |
| Treasury stock at cost (993,623 shares at 2012 and 2011)  | (2,894,068)  | (2,894,068)  |
| Accumulated other comprehensive income  | 282,263      | 382,630      |
| Total stockholders' equity  | 34,921,047   | 34,433,801   |
|   | \$48,410,283 | \$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 Six Months Ended June 30, 2012 and 2011

|  | THREE MONTHS |              | SIX MONTHS   |              |
|--|--------------|--------------|--------------|--------------|
|  | 2012         | 2011         | 2012         | 2011         |
| NET SALES                                      | \$16,904,254 | \$15,933,921 | \$35,081,332 | \$31,812,961 |
| COST OF SALES                                  | 5,964,053    | 6,088,667    | 12,775,498   | 12,442,859   |
| Gross profit                                   | 10,940,201   | 9,845,254    | 22,305,834   | 19,370,102   |
| OPERATING EXPENSES                             | 8,475,429    | 8,075,939    | 17,286,887   | 15,688,299   |
| INCOME FROM OPERATIONS                         | 2,464,772    | 1,769,315    | 5,018,947    | 3,681,803    |
| OTHER INCOME (EXPENSE):                        |              |              |              |              |
| Interest expense                               | (58,235)     | (62,132)     | (116,627)    | (124,135)    |
| Other, net                                     | 42,757       | (45,767)     | 62,571       | (94,599)     |
| Total other income (expense)                   | (15,478)     | (107,899)    | (54,056)     | (218,734)    |
| INCOME BEFORE INCOME TAXES                     | 2,449,294    | 1,661,416    | 4,964,891    | 3,463,069    |
| PROVISION FOR INCOME TAXES                     | 909,656      | 585,060      | 1,851,147    | 1,236,137    |
| NET INCOME                                     | \$1,539,638  | \$1,076,356  | \$3,113,744  | \$2,226,932  |
| NET INCOME PER COMMON SHARE:                   |              |              |              |              |
| Basic  | \$0.15       | \$0.11       | \$0.30       | \$0.22       |
| Diluted  | \$0.15       | \$0.11       | \$0.30       | \$0.22       |
| Weighted Average Number of Shares Outstanding: |              |              |              |              |
| Basic  | 10,156,442   | 10,156,442   | 10,156,442   | 10,156,442   |
| Diluted  | 10,172,171   | 10,168,098   | 10,172,561   | 10,175,561   |

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 Six Months Ended June 30, 2012 and 2011

|  | THREE MONTHS |             | SIX MONTHS  |             |
|--|--------------|-------------|-------------|-------------|
|  | 2012         | 2011        | 2012        | 2011        |
| NET INCOME                               | \$1,539,638  | \$1,076,356 | \$3,113,744 | \$2,226,932 |
| Foreign currency translation adjustments | (191,986)    | 16,607      | (100,367)   | 127,433     |
| COMPREHENSIVE INCOME                     | \$1,347,652  | \$1,092,963 | \$3,013,377 | \$2,354,365 |

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 Six Months Ended June 30, 2012 and 2011

|   | 2012               | 2011           |
|---|--------------------|----------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                    |                |
| Net income  | \$3,113,744        | \$2,226,932    |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: |                    |                |
| Depreciation and amortization   | 524,053            | 497,351        |
| Loss on disposal or abandonment of assets   | 6,145              | 79,035         |
| Non-cash stock-based compensation   | 10,000             | 26,030         |
| Deferred income taxes   | (117,930)          | 232,119        |
| Other   | (97,094)           | 117,789        |
| Net changes in assets and liabilities, net of effect of business acquisitions:              |                    |                |
| Accounts receivable-trade, net  | 209,708            | (99,985)       |
| Inventory   | (9,809,560)        | (24,219)       |
| Income taxes  | (304,657)          | (611,129)      |
| Other current assets  | (615,727)          | (298,022)      |
| Accounts payable-trade  | 1,395,665          | 250,374        |
| Accrued expenses and other liabilities  | 1,437,262          | (1,867,753)    |
| Total adjustments   | (7,362,135)        | (1,698,410)    |
| Net cash (used in) provided by operating activities   | (4,248,391)        | 528,522        |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                    |                |
| Purchase of property and equipment  | (403,611)          | (497,485)      |
| Proceeds from maturities of certificates of deposit   | 336,000            | 645,252        |
| Proceeds from sale of assets  | 1,150              | 25,473         |
| Decrease (increase) in other assets   | 3,201              | 2,841          |
| Net cash (used in) provided by investing activities   | (63,260)           | 176,081        |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |                    |                |
| Payments on notes payable and long-term debt  | (101,250)          | (101,250)      |
| Payment of cash dividend  | (2,536,131)        | -              |
| Net cash used in financing activities   | (2,637,381)        | (101,250)      |
| <b>NET CHANGE IN CASH</b>   | <b>(6,949,032)</b> | <b>603,353</b> |
| CASH, beginning of period   | 10,765,591         | 4,293,746      |
| CASH, end of period   | \$3,816,559        | 4,897,099      |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>                                   |                    |                |
| Interest paid during the period   | \$116,627          | \$124,135      |

|   |             |             |
|---|-------------|-------------|
| Income tax paid during the period, net of (refunds) | \$2,273,330 | \$1,471,101 |
|---|-------------|-------------|

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 Six Months Ended June 30, 2012 and 2011

|                               | Number of<br>Shares | Par<br>Value | Paid-in<br>Capital | Treasury<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total        |
|-------------------------------|---------------------|--------------|--------------------|-------------------|----------------------|--|--------------|
| BALANCE, December<br>31, 2010 | 10,156,422          | \$26,760     | \$5,703,387        | \$(2,894,068)     | \$26,429,335         | \$496,180  | \$29,761,594 |
| Stock-based<br>compensation   | -                   | -            | 26,030             | -                 | -                    | -  | 26,030       |
| Net income                    | -                   | -            | -                  | -                 | 2,226,932            | -  | 2,226,932    |
| Translation adjustment        | -                   | -            | -                  | -                 | -                    | 127,433  | 127,433      |
| BALANCE, June 30,<br>2011     | 10,156,422          | \$26,760     | \$5,729,417        | \$(2,894,068)     | \$28,656,267         | \$623,613  | \$32,141,989 |

|                               | Number of<br>Shares | Par<br>Value | Paid-in<br>Capital | Treasury<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total        |
|-------------------------------|---------------------|--------------|--------------------|-------------------|----------------------|--|--------------|
| BALANCE, December<br>31, 2011 | 10,156,442          | \$26,760     | \$5,736,543        | \$(2,894,068)     | \$31,181,936         | \$382,630  | \$34,433,801 |
| Stock-based<br>compensation   | -                   | -            | 10,000             | -                 | -                    | -  | 10,000       |
| Cash dividend                 | -                   | -            | -                  | -                 | (2,536,131)          | -  | (2,536,131)  |
| Net income                    | -                   | -            | -                  | -                 | 3,113,744            | -  | 3,113,744    |
| Translation adjustment        | -                   | -            | -                  | -                 | -                    | (100,367)  | (100,367)    |
| BALANCE, June 30,<br>2012     | 10,156,442          | \$26,760     | \$5,746,543        | \$(2,894,068)     | \$31,759,549         | \$282,263  | \$34,921,047 |

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) necessary to present fairly its financial position as of June 30, 2012 and December 31, 2011, and its results of operations and cash flows for the three and/or six-month periods ended June 30, 2012 and 2011. Operating results for the three and six-month periods ended June 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               |                      |
|-----------------------------------|---------------------|----------------------|
|                                   | June 30, 2012       | December 31,<br>2011 |
| <b>Inventory on hand:</b>         |                     |                      |
| Finished goods held for sale      | \$26,001,763        | \$17,742,298         |
| Raw materials and work in process | 1,377,627           | 479,686              |
| Inventory in transit              | 2,370,421           | 1,718,267            |
|                                   | <b>\$29,749,811</b> | <b>\$19,940,251</b>  |

**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

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respective goodwill balances. No indicators of impairment were identified during the first half 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 June 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   | 4,301           | -             | 4,301     |
| Impairments                  | -               | -             | -         |
| Balance, June 30, 2011       | \$611,263       | \$383,406     | \$994,669 |
|                              | Leather Factory | Tandy Leather | Total     |
| Balance, December 31, 2011   | \$603,603       | \$383,406     | \$987,009 |
| Acquisitions and adjustments | -               | -             | -         |
| Foreign exchange gain/loss   | 625             | -             | 625       |
| Impairments                  | -               | -             | -         |
| Balance, June 30, 2012       | \$604,228       | \$383,406     | \$987,634 |

Other intangibles consist of the following:

|                        | As of June 30, 2012 |              |           | As of December 31, 2011 |              |           |
|------------------------|---------------------|--------------|-----------|-------------------------|--------------|-----------|
|                        | Accumulated         |              |           | Accumulated             |              |           |
|                        | Gross               | Amortization | Net       | Gross                   | Amortization | Net       |
| Trademarks, Copyrights | \$544,369           | \$441,288    | \$103,081 | \$544,369               | \$425,418    | \$118,951 |
| Non-Compete Agreements | 182,509             | 120,550      | 61,959    | 182,365                 | 114,024      | 68,341    |
|                        | \$726,878           | \$561,838    | \$165,040 | \$726,734               | \$539,442    | \$187,292 |

We recorded amortization expense of \$22,342 during the first six months of 2012 compared to \$22,139 during the first half 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<br>Leathercraft | Retail<br>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.

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.

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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 June 30, 2012 and December 31, 2011 consisted of certificates of deposit. The contractual maturities of \$85,533 in certificates of deposit held as of June 30, 2012 are all due within one year.

## 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 June 30, 2012 and December 31, 2011, the amount outstanding under the above agreements consisted of the following:

|  | June 30, 2012 | December 31,<br>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; matures April 30, 2018 | \$ 3,206,250  | \$3,307,500          |
|  | 3,206,250     | 3,307,500            |
| Less - Current maturities  | (202,500)     | (202,500)            |
|  | \$3,003,750   | \$3,105,000          |

## 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. Under this plan, 12,000 options were awarded to directors in each of the first six 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 \$5,000 and \$7,130 for each of the quarters ended June 30, 2012 and 2011, respectively, and \$10,000 and \$26,030 for each of the six month periods ended June 30, 2012 and 2011, respectively, as a component of operating expenses.

During the six months ended June 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                      | 1.19                            | 12,000      |  |                           |
| Cancelled                    | -                               | -           |  |                           |
| Exercised                    | -                               | -           |  |                           |
| Outstanding, June 30, 2011   | \$4.40                          | 115,600     | 5.37   | \$206,332                 |
| Exercisable, June 30, 2011   | \$4.35                          | 103,600     | 5.44   | \$192,075                 |
| Outstanding, January 1, 2012 | \$4.40                          | 115,600     |  |                           |
| Granted                      | 5.27                            | 12,000      |  |                           |
| Cancelled                    | -                               | -           |  |                           |
| Exercised                    | -                               | -           |  |                           |
| Outstanding, June 30, 2012   | \$4.48                          | 127,600     | 5.13   | \$216,332                 |
| Exercisable, June 30, 2012   | \$4.40                          | 115,600     | 4.69   | \$206,332                 |

Other information pertaining to option activity during the six-month periods ended June 30, 2011 and 2010 are as follows:

|   | June 30, 2012 | June 30, 2011 |
|---|---------------|---------------|
| Weighted average grant-date fair value of stock options granted | \$10,000      | \$14,257      |
| Total fair value of stock options vested                        | N/A           | \$42,202      |
| Total intrinsic value of stock options exercised                | N/A           | N/A           |

As of June 30, 2012 and 2011, unrecognized compensation cost was \$0 and \$7,129, respectively.





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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 six months ended June 30, 2012 and 2011:

|  | Three Months Ended |             | Six Months Ended |             |
|--|--------------------|-------------|------------------|-------------|
|  | June 30,           |             | June 30,         |             |
|  | 2012               | 2011        | 2012             | 2011        |
| Numerator:   |                    |             |                  |             |
| Net income   | \$1,539,638        | \$1,076,356 | \$3,113,744      | \$2,226,932 |
| Numerator for basic and diluted earnings per share                 | 1,539,638          | 1,076,356   | 3,113,744        | 2,226,932   |
| Denominator:   |                    |             |                  |             |
| Weighted-average shares outstanding-basic                          | 10,156,442         | 10,156,442  | 10,156,442       | 10,156,442  |
| Effect of dilutive securities:                                     |                    |             |                  |             |
| Stock options  | 15,729             | 11,656      | 16,119           | 19,119      |
| Dilutive potential common shares                                   | 15,729             | 11,656      | 16,119           | 19,119      |
| Denominator for diluted earnings per share-weighted-average shares | 10,172,171         | 10,168,098  | 10,172,561       | 10,175,561  |
| Basic earnings per share   | \$0.15             | \$0.11      | \$0.30           | \$0.22      |
| Diluted earnings per share   | \$0.15             | \$0.11      | \$0.30           | \$0.22      |

The net effect of converting stock options and warrants to purchase 106,600 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 June 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.

A Proposed Settlement Agreement was signed by the parties in January 2012 and submitted to the US District Court for the Northern District of Texas (Fort Worth Division) on January 24, 2012. The Proposed Settlement Agreement is contingent on the Court's approval of its terms as well as the Court's consent to certify the proposed class and collective action class described by the parties. The Court has not yet ruled on the Proposed Settlement Agreement or the proposed class descriptions, and could either approve, reject, or suggest modifications to the Proposed Settlement Agreement. In the event the Proposed Settlement Agreement is not approved in its entirety by the Court, either party has the right to withdraw from the Proposed Settlement Agreement, in which event the litigation between the parties would proceed.

In the event the Proposed Settlement Agreement and proposed class descriptions are approved by the Court, any payments pursuant to the Proposed Settlement Agreement are conditioned on the members of the proposed class submitting a claim form approved by the Court. The total amount of payments under the Proposed Settlement Agreement to the members of the proposed class who have submitted claim forms is conditioned further on the number of claims submitted.

At this time, it is not possible to predict whether we will incur any liability, or to estimate the ranges of damages, if any, which may be incurred in connection with the matter. We intend to vigorously defend the lawsuit.

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<br>Leathercraft | Retail<br>Leathercraft | Int'l<br>Leathercraft | Total        |
|-------------------------------------|---------------------------|------------------------|-----------------------|--------------|
| For the quarter ended June 30, 2012 |                           |                        |                       |              |
| Net sales                           | \$6,282,990               | \$9,863,139            | \$758,125             | \$16,904,254 |
| Gross profit                        | 4,273,989                 | 6,145,188              | 521,024               | 10,940,201   |
| Operating earnings                  | 1,103,311                 | 1,309,503              | 51,958                | 2,464,772    |
| Interest (expense)                  | (58,235)                  | -                      | -                     | (58,235)     |
| Other income (expense), net         | 12,299                    | -                      | 30,458                | 42,757       |
| Income before income taxes          | 1,057,375                 | 1,309,503              | 82,416                | 2,449,294    |
| Depreciation and amortization       | 203,927                   | 46,465                 | 14,125                | 264,517      |
| Fixed asset additions               | 102,598                   | 141,537                | 19,635                | 263,770      |
| Total assets                        | \$36,240,356              | \$9,358,545            | \$2,811,382           | \$48,410,283 |

|                                     |              |             |             |              |
|-------------------------------------|--------------|-------------|-------------|--------------|
| For the quarter ended June 30, 2011 |              |             |             |              |
| Net sales                           | \$6,471,072  | \$8,934,306 | \$528,543   | \$15,933,921 |
| Gross profit                        | 4,106,707    | 5,383,078   | 355,469     | 9,845,254    |
| Operating earnings                  | 608,385      | 1,038,301   | 122,629     | 1,769,315    |
| Interest (expense)                  | (62,132)     | -           | -           | (62,132)     |
| Other income (expense), net         | (45,436)     | -           | (331)       | (45,767)     |
| Income before income taxes          | 500,817      | 1,038,301   | 122,298     | 1,661,416    |
| Depreciation and amortization       | 211,290      | 38,436      | 2,621       | 252,347      |
| Fixed asset additions               | 173,914      | 154,385     | -           | 328,299      |
| Total assets                        | \$33,191,853 | \$6,577,192 | \$1,145,764 | \$40,914,809 |

|  | Wholesale<br>Leathercraft | Retail<br>Leathercraft | Int'l<br>Leathercraft | Total        |
|--|---------------------------|------------------------|-----------------------|--------------|
| For the six months ended June 30, 2012 |                           |                        |                       |              |
| Net sales                              | \$13,435,407              | \$20,145,953           | \$1,499,972           | \$35,081,332 |
| Gross profit                           | 8,803,672                 | 12,517,333             | 984,829               | 22,305,834   |
| Operating earnings                     | 2,336,163                 | 2,668,228              | 14,556                | 5,018,947    |
| Interest (expense)                     | (116,627)                 | -                      | -                     | (116,627)    |
| Other income (expense), net            | 28,347                    | 13                     | 34,211                | 62,571       |
| Income before income taxes             | 2,247,883                 | 2,668,241              | 48,767                | 4,964,891    |
| Depreciation and amortization          | 407,617                   | 89,916                 | 26,520                | 524,053      |
| Fixed asset additions                  | 134,224                   | 196,291                | 73,096                | 403,611      |
| Total assets                           | \$36,240,356              | \$9,358,545            | \$2,811,382           | \$48,410,283 |

|  |              |              |             |              |
|--|--------------|--------------|-------------|--------------|
| For the six months ended June 30, 2011 |              |              |             |              |
| Net sales                              | \$13,191,781 | \$17,583,458 | \$1,037,722 | \$31,812,961 |
| Gross profit                           | 8,048,277    | 10,651,126   | 670,699     | 19,370,102   |
| Operating earnings                     | 1,418,439    | 2,040,602    | 222,762     | 3,681,803    |
| Interest expense                       | (124,135)    | -            | -           | (124,135)    |
| Other income (expense), net            | (111,782)    | -            | 17,183      | (94,599)     |
| Income before income taxes             | 1,182,522    | 2,040,602    | 239,945     | 3,463,069    |
| Depreciation and amortization          | 419,478      | 72,761       | 5,112       | 497,351      |
| Fixed asset additions                  | 281,328      | 214,657      | 1,500       | 497,485      |

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Total assets \$33,191,853 \$6,577,192 \$1,145,764 \$40,914,809

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

| Three months ended June 30, | 2012         | 2011         |
|-----------------------------|--------------|--------------|
| United States               | \$14,112,191 | \$13,459,312 |
| Canada                      | 1,732,982    | 1,685,746    |
| All other countries         | 1,059,081    | 788,863      |
|                             | \$16,904,254 | \$15,933,921 |
| Six months ended June 30,   | 2012         | 2011         |
| United States               | \$29,639,646 | \$26,978,244 |
| Canada                      | 3,452,822    | 3,271,270    |
| All other countries         | 1,988,864    | 1,563,447    |
|                             | \$35,081,332 | \$31,812,961 |

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 six-month periods ended June 30, 2012 and 2011. We do not have any significant long-lived assets outside of the United States.

#### 9. SUBSEQUENT EVENTS

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% and matures on June 30, 2013. As of August 10, 2012, borrowings totaled \$500,000 were outstanding under the above agreement.

Also in July 2012, we began construction on a 23,000 square foot building located on our corporate property at 1900 Southeast Loop 820, Fort Worth, Texas. This building will house our premier store that is currently located in rented space in Fort Worth, Texas. The building is expected to cost \$2.6 million and should be completed in the first quarter of 2013. We anticipate that we will pay for the building from a combination of current cash balances, internally-generated funds and our revolving credit facility with JPMorgan Chase Bank.

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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 Global Market under the symbol "TLF." We operate our business in three segments: Wholesale Leathercraft, which operates wholesale stores in North America under the trade name, The Leather Factory, Retail Leathercraft, which operates retail stores in North America under the trade name, Tandy Leather Company, and International Leathercraft, which operates combination retail/wholesale stores outside of North America under the trade name, Tandy Leather Factory. See Note 8 to the Consolidated Financial Statements for additional information concerning our segments, as well as our foreign operations.

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

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

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

Critical Accounting Policies

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

Forward-Looking Statements

Certain statements contained in this report and other materials we file with the Securities and Exchange Commission, as well as information included in oral statements or other written statements made or to be made by us, other than statements of historical fact, are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements generally are accompanied by words such as "may," "will," "could," "should," "anticipate," "believe," "budgeted," "intend," "plan," "project," "potential," "estimate," "continue," or "future" variations thereof or other similar statements. 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, 2011 for additional information concerning these

and other uncertainties that could negatively impact the Company.

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

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

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

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

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

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

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

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





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## Results of Operations

## Three Months Ended June 30, 2012 and 2011

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

|                        | Quarter Ended June 30, 2012 |                  | Quarter Ended June 30, 2011 |                  |
|------------------------|-----------------------------|------------------|-----------------------------|------------------|
|                        | Sales                       | Operating Income | Sales                       | Operating Income |
| Wholesale Leathercraft | \$6,282,990                 | \$1,103,311      | \$6,471,072                 | \$608,385        |
| Retail Leathercraft    | 9,863,139                   | 1,309,503        | 8,934,306                   | 1,038,301        |
| Int'l Leathercraft     | 758,125                     | 51,958           | 528,543                     | 122,629          |
| Total Operations       | \$16,904,254                | \$2,464,772      | \$15,933,921                | \$1,769,315      |

Consolidated net sales for the quarter ended June 30, 2012 increased \$970,000, or 6.1%, compared to the same period in 2011. Our Retail Leathercraft and International Leathercraft segments achieved sales gains of 10% and 43%, respectively, while Wholesale Leathercraft reported a sales decline of 2.9%. Operating income on a consolidated basis for the quarter ended June 30, 2012 was up 39.3%, or \$695,000, from the second quarter of 2011.

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

|            | 2012        | 2011        | % change |
|------------|-------------|-------------|----------|
| Net income | \$1,539,638 | \$1,076,356 | 43.0%    |

All segments contributed to our increased consolidated net income. Additional information appears below for each segment.

## Wholesale Leathercraft

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

| Customer Group  | Quarter Ended |          |
|---|---------------|----------|
|   | 06/30/12      | 06/30/11 |
| RETAIL (end users, consumers, individuals)  | 33%           | 31%      |
| INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.)     | 8%            | 6%       |
| WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.) | 44%           | 45%      |
| MANUFACTURERS   | 9%            | 7%       |
| NATIONAL ACCOUNTS   | 6%            | 11%      |
|   | 100%          | 100%     |

Net sales decreased 2.9%, or \$188,000, for the second quarter of 2012 as follows:

| # Stores | Qtr Ended 06/30/12 | Qtr Ended 06/30/11 | \$ Change | % Change |
|----------|--------------------|--------------------|-----------|----------|
|          |                    |                    |           |          |

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|                        |    |             |             |             |         |
|------------------------|----|-------------|-------------|-------------|---------|
| Same store sales       | 29 | \$6,070,345 | \$5,838,551 | \$231,794   | 4.0%    |
| National account group |    | 212,645     | 632,521     | (419,876)   | (66.4)% |
| Total sales            |    | \$6,282,990 | \$6,471,072 | \$(188,082) | (2.9)%  |

Our same store sales increased 4% in the second quarter of 2012, as compared with the same period in 2011. Compared to the second quarter of 2011, we achieved sales dollar increases in our institution and wholesale customer categories, which were offset somewhat by decreases in our retail and national account customer categories. The increase in sales to our institution customers is the result of an increase in sales to summer camps and youth programs this year. Our wholesale customers appear to have stabilized somewhat, but with the uncertainty surrounding the domestic economy overall, we are not assured that this stabilization will continue. Sales to our National Account customers were down 66% for the quarter, compared to the same quarter last year. Our sales to these customers are dependent on what products we are willing to develop specifically for this group and the level of inventory we are willing to house in anticipation of orders. We have intentionally eliminated some products from our line because the gross profit margins were lower than we were willing to accept. Therefore, it is likely we will experience further sales declines to our National Account group if the product we stock is not what these customers want to purchase. Our primary focus is on sales through our stores, rather than National Accounts, as we believe our stores represent the greatest potential for continued and consistent sales growth.

Operating income for Wholesale Leathercraft during the quarter ended June 30, 2012 increased by \$495,000 from the comparative 2011 quarter, an increase of 81%. Operating expenses as a percentage of sales were 50.5%, down \$332,000 from the second quarter of 2011. Decreases in legal fees of \$227,000, due to a reduction in consultations with attorneys on various matters, and employee benefits of \$150,000, namely our employee health care benefit program, were the primary contributors to the operating expense reduction.

Retail Leathercraft

Our Retail Leathercraft segment consists of 77 Tandy Leather Company retail stores at June 30, 2012 and 2011. Net sales increased 10.4% for the second quarter of 2012 over the same quarter last year. A store is categorized as “new” until it is operating for the full comparable period in the prior year.

|                  | #<br>Stores | Qtr Ended<br>06/30/12 | Qtr Ended<br>06/30/11 | \$<br>Change | %<br>Change |
|------------------|-------------|-----------------------|-----------------------|--------------|-------------|
| Same store sales | 76          | \$9,768,973           | \$8,924,874           | \$844,099    | 9.5%        |
| New store sales  | 1           | 94,166                | 9,432                 | 84,734       | N/A         |
| Total sales      |             | \$9,863,139           | \$8,934,306           | \$928,833    | 10.4%       |

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

| Customer Group  | Quarter Ended |          |
|---|---------------|----------|
|   | 06/30/12      | 06/30/11 |
| RETAIL (end users, consumers, individuals)  | 58%           | 60%      |
| INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.)     | 6%            | 7%       |
| WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.) | 34%           | 31%      |
| NATIONAL ACCOUNTS   | -             | -        |
| MANUFACTURERS   | 2%            | 2%       |
|   | 100%          | 100%     |



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

Sales to each customer group increased solidly over the second quarter of 2011, with the exception of our institution customer group. Operating income increased \$271,000, or 26.1%, from the comparative 2011 quarter. Operating income as a percentage of sales also increased from 11.6% in the second quarter of 2011 to 13.3% in the second quarter of 2012. Our gross profit margin improved from 60.3% to 62.3%. Operating expenses as a percentage of sales increased from 48.6% to 49.0% as expenses grew at a slightly higher rate than that of sales during the quarter. Operating expenses increased \$495,000 over the second quarter of 2011. Compared to last year's second quarter, employee compensation and benefits increased \$221,000, advertising and marketing expenses increased \$70,000, due to special advertising related to store relocations, travel expense associated with store relocations increased \$20,000, and legal/professional fees increased \$10,000. Rent and utilities increased \$85,000 as we continue to move stores into larger locations.

## International Leathercraft

International Leathercraft consists of all stores located outside of North America. As of June 30, 2012, the segment contained three stores located in United Kingdom, Australia, and Spain. As of June 30, 2011, the segment consisted of the one store located in the United Kingdom. Net sales increased 43.4% for the second quarter of 2012 over the same quarter last year. A store is categorized as "new" until it is operating for the full comparable period in the prior year.

|                  | #<br>Stores | Qtr Ended<br>06/30/12 | Qtr Ended<br>06/30/11 | \$<br>Change | %<br>Change |
|------------------|-------------|-----------------------|-----------------------|--------------|-------------|
| Same store sales | 1           | \$485,350             | \$528,543             | \$(43,193)   | (8.2%)      |
| New store sales  | 2           | 272,775               | -                     | 272,774      | N/A         |
| Total sales      |             | \$758,125             | \$528,543             | \$229,582    | 43.4%       |

Gross profit margin as a percentage of sales increased from 67.3% in the second quarter of 2011 to 68.7% in the second quarter of 2012. We determine selling prices taking into consideration the currency conversion between the U.S. dollar and the local currency. Further, these stores generate higher profit margins than that of a comparable U.S. store due to a beneficial product mix, selling more higher margin tools and supplies and less lower margin leather. Operating expenses totaled \$469,000 in the second quarter of 2012, up from \$233,000 in the second quarter of 2011, all attributable to the new stores' operations. Employee compensation is this division's largest expense, followed by advertising, shipping costs to customers, and rent.

## Other Expenses

We paid \$58,000 in interest expense in the second quarter of 2012 on our bank debt, which is related to our building purchase, compared to \$62,000 in interest expense in the second quarter last year. Due to the reduction in cash on hand compared to last year, we earned \$1,000 in interest income during the second quarter of 2012, down from last year's second quarter interest income earned of \$10,000. We recorded income of \$30,000 during the second quarter of 2012 related to currency fluctuations from our international operations. Comparatively, in the second quarter of 2011, we recorded a loss of \$66,000 for currency fluctuations.

## Six Months Ended June 30, 2012 and 2011

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

| Six Months Ended June 30, 2012 | Six Months Ended June 30, 2011 |
|--------------------------------|--------------------------------|
| Sales                          | Sales                          |

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|                            |              | Operating<br>Income |              | Operating<br>Income |
|----------------------------|--------------|---------------------|--------------|---------------------|
| Wholesale Leathercraft     | \$13,435,407 | \$2,336,163         | \$13,191,781 | \$1,418,439         |
| Retail Leathercraft        | 20,145,953   | 2,668,228           | 17,583,458   | 2,040,602           |
| International Leathercraft | 1,499,972    | 14,556              | 1,037,722    | 222,762             |
| Total Operations           | \$35,081,332 | \$5,018,947         | \$31,812,961 | \$3,681,803         |

Consolidated net sales for the six months ended June 30, 2012 were up 10% compared to the same period in 2011, increasing \$3.3 million. All three reporting segments contributed to the sales increase. Retail Leathercraft contributed the largest sales increase of \$2.6 million, followed by International Leathercraft reporting an increase of \$462,000 and Wholesale Leathercraft reporting an increase of \$244,000. Operating income on a consolidated basis for the six months ended June 30, 2012 was up 36.3% compared to the first half of 2011, increasing \$1.3 million.

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

|            | 2012        | 2011        | % change |
|------------|-------------|-------------|----------|
| Net income | \$3,113,744 | \$2,226,932 | 39.8%    |

Wholesale Leathercraft

Net sales increased 1.8%, or \$244,000, for the first half of 2012 as follows:

|                        | #<br>Stores | Six Months<br>Ended<br>06/30/12 | Six Months<br>Ended<br>06/30/11 | \$<br>Change | %<br>Change |
|------------------------|-------------|---------------------------------|---------------------------------|--------------|-------------|
| Same store sales       | 29          | \$12,411,129                    | \$11,771,831                    | \$639,298    | 5.4%        |
| National account group |             | 1,024,278                       | 1,419,950                       | (395,672)    | (27.9)%     |
| Total sales            |             | \$13,435,407                    | \$13,191,781                    | \$243,626    | 1.8%        |

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

| Customer Group  | Six Months Ended |          |
|---|------------------|----------|
|   | 06/30/12         | 06/30/11 |
| RETAIL (end users, consumers, individuals)  | 33%              | 31%      |
| INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.)     | 6%               | 6%       |
| WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.) | 44%              | 44%      |
| MANUFACTURERS   | 7%               | 7%       |
| NATIONAL ACCOUNTS   | 10%              | 12%      |
|   | 100%             | 100%     |

Operating income for Wholesale Leathercraft for the first half of 2012 increased by \$918,000 from the comparative 2011 period, an improvement of 64.7%. Compared to the first six months of 2011, operating expenses decreased \$168,000 for the first half of 2012, decreasing as a percentage of sales from 50.3% to 48.1%.

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## Retail Leathercraft

Net sales were up 14.6% for the first half of 2012 over the same period last year.

|                             | #<br>Stores | Six Months<br>Ended<br>06/30/12 | Six Months<br>Ended<br>06/30/11 | \$<br>Change | %<br>Change |
|-----------------------------|-------------|---------------------------------|---------------------------------|--------------|-------------|
| Same (existing) store sales | 76          | \$19,946,496                    | \$17,574,026                    | \$2,372,470  | 13.5%       |
| New store sales             | 1           | 199,457                         | 9,432                           | 190,025      | N/A         |
| Total sales                 |             | \$20,145,953                    | \$17,583,458                    | \$2,562,495  | 14.6%       |

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

| Customer Group  | Six Months Ended |          |
|---|------------------|----------|
|   | 06/30/12         | 06/30/11 |
| RETAIL (end users, consumers, individuals)  | 60%              | 62%      |
| INSTITUTION (prisons, prisoners, hospitals, schools, youth organizations, etc.)     | 5%               | 6%       |
| WHOLESALE (resellers & distributors, saddle & tack shops, authorized dealers, etc.) | 32%              | 30%      |
| NATIONAL ACCOUNTS   | -                | -        |
| MANUFACTURERS   | 3%               | 2%       |
|   | 100%             | 100%     |

The retail stores averaged approximately \$43,000 in sales per month for the first half of 2012.

Operating income for the first six months of 2012 increased \$628,000 from the comparative 2011, improving as a percentage of sales from 11.6% in the first half of 2011 to 13.2% in the first half of 2012. Gross margin increased slightly from 60.6% to 62.1%. Operating expenses as a percentage of sales were 48.9% for both the first half of 2012 and 2011, as sales grew slightly faster than expenses.

## International Leathercraft

International Leathercraft consists of all stores located outside of North America. As of June 30, 2012, the segment contained three stores with one each located in United Kingdom, Australia, and Spain. As of June 30, 2011, the segment consisted of the one store located in the United Kingdom. Net sales increased 44.5% for the first half of 2012 over the same period last year. A store is categorized as “new” until it is operating for the full comparable period in the prior year.

|                  | #<br>Stores | Six Months<br>Ended<br>06/30/12 | Six Months<br>Ended<br>06/30/11 | \$<br>Change | %<br>Change |
|------------------|-------------|---------------------------------|---------------------------------|--------------|-------------|
| Same store sales | 1           | \$1,015,206                     | \$1,037,722                     | \$(22,516)   | (2.2)       |
| New store sales  | 2           | 484,766                         | -                               | 484,766      | N/A         |
| Total sales      |             | \$1,499,972                     | \$1,037,722                     | \$462,250    | 44.5%       |

Gross profit margin as a percentage of sales increased from 64.6% in the first half of 2011 to 65.7% in the first half of 2012. Selling prices are determined based on the currency conversion between the U.S. dollar and the local currency. In addition, gross profit margin is affected by sales mix – the ratio of higher margin products (tools, supplies,

etc.) to lower margin products (leather). Operating expenses totaled \$970,000 in the first half of 2012, up from \$448,000 in the first half of 2011, all attributable to the new stores' operations. Employee compensation is this segment's largest expense, followed by advertising and marketing expenses, shipping costs to customers, and rent.

#### Other Expenses

We paid \$117,000 in interest on our bank debt in the first six months of 2012, compared to \$124,000 in the first six months of 2011. Due to the reduction in cash on hand compared to last year, we recorded \$6,000 in interest income on our cash balances in the six months ended June 30, 2012 compared to \$17,000 a year ago. We recorded income of \$34,000 for currency fluctuations in the first half of 2012. Comparatively, in the first half of 2011, we recorded an expense of \$138,000 for currency fluctuations.

#### Capital Resources, Liquidity and Financial Condition

On our consolidated balance sheet, total assets were \$48.4 million at June 30, 2012, up \$2.9 million from \$45.5 million at year-end 2011. Total stockholders' equity increased from \$34.4 million at December 31, 2011 to \$34.9 million at June 30, 2012, the increase being attributable to earnings in the first half of this year, partially offset by the cash dividend of \$2.5 million paid to stockholders in April. Our current ratio decreased from 4.7 at December 31, 2011 to 3.8 at June 30, 2012 as current liabilities grew faster than current assets.

Our investment in inventory increased by \$9.8 million from year-end 2011 to June 30, 2012. Inventory turnover reached an annualized rate of 2.82 times during the first half of 2012, slightly less than 3.14 times for the first half of 2011. Inventory turnover was 3.29 times for all of 2011. We compute our inventory turns as sales divided by average inventory. As of June 30, 2012, our total inventory on hand was approximately 16% over our internal targets for optimal inventory levels. We have increased the amount of inventory carried in our stores to provide our customers with greater product selection and to promote continued sales growth. We are also stocking additional inventory to support our growing International Leathercraft segment. Further, we have taken advantage of numerous opportunities to make bulk purchases of our stock leathers at special pricing during the second quarter, normally made during the third quarter.

Trade accounts receivable was \$1.1 million at June 30, 2012, down \$210,000 from \$1.3 million at year-end 2011. The average days to collect accounts for the first half of 2012 were 47 days, matching that of the first half of 2011. We are monitoring our customer accounts very closely in order to minimize the risk of uncollectible accounts in the current economic environment.

Accounts payable increased to \$3.0 million at June 30, 2012 compared to \$1.6 million at year-end 2011, primarily due to the increase in inventory purchases during the first half of 2012. Accrued expenses increased \$1.4 million from December 31, 2011 to June 30, 2012 due to the increase of inventory in transit compared to year-end 2011.

During the first six months of 2012, cash flow used by operating activities was \$4.2 million. The increase in inventory of \$9.8 million, offset by net income of \$3.1 million, the increase in accounts payable of \$1.4 million and the increase in accrued liabilities of \$1.4 million accounted for the majority of the operating cash used in the six months.

By comparison, during the first six months of 2011, cash flow provided by operating activities was \$529,000. Net income of \$2.2 million was offset by a reduction in accrued liabilities of \$1.9 million and accounted for the majority of the operating cash provided in the first six months. Accrued liabilities decreased from December 31, 2010 to June 30, 2011 due to the payment of manager bonuses and the reduction in inventory in transit.

Cash flow used in investing activities totaled \$63,000 in the first half of 2012, consisting primarily of purchases of store fixtures and computer equipment, partially offset by maturities of certificates of deposit. In the first half of

2011, cash provided by investing activities totaled \$176,000, consisting primarily of maturities of certificates of deposit, partially offset by purchases of fixtures and equipment.

Cash flow used in financing activities totaled \$2.6 million in the first six months of 2012, consisting of a special one-time cash dividend of \$2.5 million and \$101,000 in debt repayments. In the first six months of 2011, cash flow used in financial activities totaled \$101,000, consisting debt repayments of \$101,000.

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

### Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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



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## Item 4. Controls and Procedures.

## Evaluation of Disclosure Controls and Procedures

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

## Changes in Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting during the fiscal quarter ended June 30, 2012 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

## Item 1. Legal Proceedings

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

## Item 6. Exhibits.

| Exhibit Number | Description  |
|----------------|--|
| 3.1            | Certificate of Incorporation of The Leather Factory, Inc., and Certificate of Amendment to Certificate of Incorporation of The Leather Factory, Inc. filed as Exhibit 3.1 to Form 10-Q filed by Tandy Leather Factory, Inc. with the Securities and Exchange Commission on August 12, 2005 and incorporated by reference herein. |
| 3.2            | Bylaws of The Leather Factory, Inc., filed as Exhibit 3.5 to the Current Report on Form 8-K (Commission File No. 001-12368) filed by Tandy Leather Factory, Inc (f/k/a The Leather Factory, Inc.) with the Securities and Exchange Commission on July 14, 2004 and incorporated by reference herein.                             |
| *10.1          | Line of Credit Note, dated June 21, 2012, by and between The Leather Factory, L.P. and JPMorgan Chase Bank, N.A.   |
| *31.1          | 13a-14(a) or 15d-14(a) Certification by Jon Thompson, Chief Executive Officer and President.   |

\*31.2 13a-14(a) or 15d-14(a) Certification by Shannon Greene, Chief Financial Officer and Treasurer.

\*32.1 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101.INS<sup>^</sup> XBRL Instance Document.

101.SCH<sup>^</sup> XBRL Taxonomy Extension Schema Document.

101.CAL<sup>^</sup> XBRL Taxonomy Extension Calculation Document.

101.DEF<sup>^</sup> XBRL Taxonomy Extension Definition Document.

101.LAB<sup>^</sup> XBRL Taxonomy Extension Labels Document.

101.PRE<sup>^</sup> XBRL Taxonomy Extension Presentation Document.

<sup>^</sup>Filed herewith.

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

#### SIGNATURES

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

TANDY LEATHER FACTORY, INC.  
(Registrant)

Date: August 13, 2012

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

Date: August 13, 2012

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