

TANDY LEATHER FACTORY INC
Form 10-K
March 31, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-K

(Mark One)

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

For the fiscal year ended December 31, 2008

OR

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

For the transition period _____ 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)

75-2543540
(IRS Employer Identification Number)

1900 Southeast Loop 820, Fort Worth,
TX 76140
(Address of principal executive offices)

817/872-3200
(Registrant's telephone number, including area
code)

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class | Name of Each Exchange on Which Registered |
|----------------------------------|---|
| Common Stock, par value \$0.0024 | NYSE Amex |

Securities registered pursuant to Section 12(g) of the Act: NONE

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. []

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

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

The aggregate market value of the common stock held by non-affiliates of the registrant was approximately \$22,193,469 at June 30, 2008 (the last business day of its most recently completed second fiscal quarter). At March 10, 2009, there were 10,664,555 shares of the registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's definitive Proxy Statement for the Annual Meeting of Stockholders to be held on May 12, 2009, are incorporated by reference in Part III of this report.

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PART I

ITEM 1. BUSINESS

General

We are a retailer and wholesale distributor of a broad line of leather and related products, including leather, leatherworking tools, buckles and adornments for belts, leather dyes and finishes, saddle and tack hardware, and do-it-yourself kits. We also manufacture leather lacing and kits. During 2008, our consolidated sales totaled \$53.2 million of which approximately 13% were export sales. We maintain our principal offices at 1900 Southeast Loop 820, Fort Worth, Texas 76140. Our common stock trades on the NYSE Amex (formerly the American Stock Exchange) under the symbol "TLF."

Our company was founded in 1980 as Midas Leathercraft Tool Company, a Texas corporation. Midas' original business activity focused on the distribution of leathercraft tools. In addition, the founders of Midas entered into a consulting agreement with Brown Group, Inc., a major footwear retailer, as a result of their proposal to develop a multi-location chain of wholesale stores known as "The Leather Factory." In 1985, Midas purchased the assets of The Leather Factory from Brown Shoe Group, which then consisted of six wholesale stores.

In 1993, we changed our name to "The Leather Factory, Inc.", then reincorporated in the state of Delaware in 1994. In 2005, we changed our name to Tandy Leather Factory, Inc.

Our Development in Recent Years

We have expanded our wholesale chain by opening new stores and by numerous acquisitions of small businesses in strategic geographic locations including the acquisition of our Canadian distributor, The Leather Factory of Canada, Ltd., in 1996. By 2000, we had grown to 27 Leather Factory stores located in the United States and two Leather Factory stores in Canada. In November 2000, we acquired the operating assets of two subsidiaries of Tandy Leather Company, Inc. to form Tandy Leather Company. In 2002, we began opening retail stores under the "Tandy Leather" name. During that year, Tandy Leather purchased four independent leathercraft retail stores and opened another 10. We also opened our thirtieth Leather Factory store - our third in Canada. In 2003, we opened 12 Tandy Leather retail stores. In 2004, we purchased three independent leathercraft retail stores and opened an additional nine stores in the U.S. We also opened another store in Canada which is operating as a Tandy Leather retail store. In November 2004, we acquired all of the issued and outstanding shares of capital stock of Heritan Ltd. and its parent, our primary Canadian competitor, headquartered in Barrie, Ontario. The acquisition resulted in an additional three retail stores in Canada, bringing the total locations in Canada to seven - three Leather Factory stores and four Tandy Leather stores. In 2005, we opened eight Tandy Leather retail stores. In 2006, we opened 11 Tandy Leather retail stores and converted one wholesale store to a retail store. In 2007, we purchased one independent leathercraft store and opened an additional nine retail stores - eight in the U.S. and one in Canada. We also purchased Mid-Continent Leather Sales, Inc., a competitor located in Oklahoma, which became our thirtieth wholesale store. In 2008, we opened one retail store in the U.S. and one combination wholesale and retail store in Northampton, United Kingdom.

At December 31, 2008, we operated 30 wholesale stores - 29 operating under the Leather Factory name (26 in the U.S. and three in Canada) and one operating under the Mid-Continent Leather Sales name. We also operated 73 retail stores operating under the Tandy Leather name (67 in the U.S. and six in Canada) as well as one combination wholesale and retail store operating under the Tandy Leather Factory name in the United Kingdom. Finally, we also own and operate Roberts, Cushman and Company, Inc., a distributor of custom hat trims.

Our growth, measured both by our net sales and net income, occurs as a result of the increase in the number of stores we have and the increase from year to year of the sales in our existing stores. The following tables provide summary information concerning the additions of facilities for our Leather Factory wholesale stores and Tandy Leather retail stores in each of our fiscal years from 1999 to 2008.

STORE COUNT
YEARS ENDED DECEMBER 31, 1999 through 2008

| Year Ended | Leather Factory wholesale stores | | | Tandy Leather retail stores | | |
|-------------|----------------------------------|----------------|-------|-----------------------------|--------|-------|
| | Opened | Conversions(1) | Total | Opened (2) | Closed | Total |
| Balance Fwd | | | 22 | | | N/A |
| 1999 | 4 | 0 | 26 | | | N/A |
| 2000 | 2 | 0 | 28 | 1* | 0 | 1 |
| 2001 | 2 | 0 | 30 | 0 | 0 | 1 |
| 2002 | 1 | (1) | 30 | 14 | 1* | 14 |
| 2003 | 0 | 0 | 30 | 12 | 0 | 26 |
| 2004 | 0 | 0 | 30 | 16 | 0 | 42 |
| 2005 | 0 | 0 | 30 | 8 | 0 | 50 |
| 2006 | 0 | (1) | 29 | 12 | 0 | 62 |
| 2007 | 1^ | 0 | 30 | 10 | 0 | 72 |
| 2008 | 0 | 0 | 30 | 1 | 0 | 73 |

(1) Leather Factory wholesale store converted to a Tandy Leather retail store.

(2) Includes conversions of Leather Factory wholesale stores to Tandy Leather retail stores.

(*) The Tandy Leather operation began as a central mail-order fulfillment center in 2000 which was closed in 2002.

(^) Wholesale store operating as Mid-Continent Leather Sales

No single customer's purchases represent more than 5% of our total sales in 2008. Sales to our five largest customers combined to represent 6.2%, 8.3% and 9.5%, respectively, of consolidated sales in 2008, 2007 and 2006. While management does not believe the loss of one of these customers would have a significant negative impact on our operations, it does believe the loss of several of these customers simultaneously or a substantial reduction in sales generated by them could temporarily affect our operating results.

Our Operating Divisions

We service our customers primarily through the operation of four divisions. We identify those divisions based on management responsibility and customer focus. The Wholesale Leathercraft division consists of thirty wholesale stores of which 27 are located in the United States and three are located in Canada. As of March 1, 2009, the Retail Leathercraft division consists of 74 Tandy Leather retail stores of which 68 are located in the United States and six are located in Canada. Both of these divisions sell leather and leathercraft-related products. The International Leathercraft division consists of all stores, wholesale or retail, located outside of North America. Currently, we have one such store located in the United Kingdom. Our fourth business segment, referred to as "Other," consists of our hatband manufacturer, Roberts, Cushman & Company, Inc.

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Wholesale Leathercraft

The Wholesale Leathercraft operation distributes its broad product line of leather and leathercraft-related products in the United States and internationally through Leather Factory stores. This segment had net sales of \$26.4 million, \$29.6 million and \$31.0 million for 2008, 2007 and 2006, respectively. The wholesale stores operate under the name “The Leather Factory”, with the exception of the one store we acquired in February 2007 which operates under the name “Mid-Continent Leather Sales.”

General We operate wholesale stores in 20 states and three Canadian provinces. The centers range in size from 2,600 square feet to 19,800 square feet, with the average size of a store being approximately 6,000 square feet. The type of premises utilized for our wholesale stores is generally light industrial office/warehouse space in proximity to a major freeway or with other similar access. This type of location typically offers lower rents compared to other more retail-oriented locations.

Business Strategy The Leather Factory business concept centers around the wholesale distribution of leather and related accessories to retailers, manufacturers and end users. Our strategy is that a customer can purchase the leather, related accessories and supplies necessary to complete his project from one place. The size and layout of the centers are planned to allow large quantities of product to be displayed in an easily accessible and visually appealing manner. Leather is displayed by the pallet where the customer can see and touch it, assessing first-hand the numerous sizes, styles and grades offered. The location of the stores is selected based on the location of customers, so that delivery time to customers is minimized. A two-day maximum delivery time for phone, internet and mail orders is our goal.

Our wholesale stores serve customers through various means including walk-in traffic, phone and mail order. We also employ a distinctive marketing tactic in that we maintain an internally-developed target customer mailing list for use in our aggressive direct mail advertising campaigns. We staff our stores with experienced managers whose compensation is tied to the operating profit of the store they manage. Sales are generated by the selling efforts of the store personnel, our direct mail advertising, our website (www.tandy-leatherfactory.com), our participation at trade shows and, on a limited basis, the use of sales representative organizations. The sales representative organizations consist of companies located in specific geographic areas that represent numerous companies in a similar industry. These organizations call on customers and show multiple products from more than one vendor at a time.

Customers Our customer base consists of individuals, wholesale distributors, tack and saddle shops, institutions (prisons and prisoners, schools, hospitals), western stores, craft stores and craft store chains, other large volume purchasers, manufacturers and retailers dispersed geographically throughout the world. Wholesale sales constitute the majority of our business, although retail customers may purchase products from our wholesale stores. The Wholesale Leathercraft division’s sales generally do not reflect significant seasonal patterns.

Our Authorized Sales Center (“ASC”) program was developed to create a presence in geographical areas where we do not have a wholesale store. An unrelated person operating an existing business who desires to become an ASC must submit an application and upon approval, place a minimum initial order. There are also minimum annual purchase amounts to which the ASC must adhere in order to maintain ASC status. In exchange, the benefits to the ASC are free advertising in various sale flyers produced and distributed by us, price breaks on many products, advance notice of new products, and priority shipping and handling on all orders. Our wholesale stores service 151 ASC's: 87 located in the U.S., 42 located in Canada, and 22 located outside North America.

Merchandise Our products are generally organized into thirteen categories. We carry a wide assortment of products including leather, lace, hand tools, kits and craft supplies. We operate a light manufacturing facility in Fort Worth whose processes generally involve cutting leather into various shapes and patterns using metal dies. The factory produces approximately 20% of our products and also assembles and repackages products as needed. Products

manufactured in our factory are distributed through our stores under the Tejas™ brand name. We also distribute product under the Tandy Leather™ and Dr. Jackson's™ brands. We develop new products through the ideas and referrals of customers and store personnel as well as the tracking of fads and trends of interest in the market.

We offer an unconditional satisfaction guarantee to our customers. Simply stated, we will accept product returns for any reason. We believe this liberal policy promotes customer loyalty. We offer credit terms to our non-retail customers, upon receipt of a credit application and approval by our credit manager. Generally, our open accounts are net 30 days.

During 2008 and 2007, Wholesale Leathercraft division sales by product category were as follows:

| Product Category | 2008 Sales Mix | 2007 Sales Mix |
|---------------------------|-------------------|-------------------|
| Belts strips and straps | 2% | 3% |
| Books, patterns, videos | 1% | 2% |
| Buckles | 4% | 4% |
| Conchos [^] | 5% | 4% |
| Craft supplies | 6% | 4% |
| Custom tools and hardware | 0% | 0% |
| Dyes, finishes, glues | 6% | 5% |
| Hand tools | 12% | 12% |
| Hardware | 7% | 8% |
| Kits | 8% | 7% |
| Lace | 9% | 10% |
| Leather | 36% | 37% |
| Stamping tools | 4% | 4% |
| | 100% | 100% |

[^]A concho is a metal adornment attached to clothing, belts, saddles, etc., usually made into a pattern of some southwestern or geometric object.

In addition to meeting ordinary operational requirements, our working capital demands are a product of the need to maintain a level of inventory sufficient to fill customer orders as they are received with minimal backorders and the time required to collect our accounts receivable. Because availability of merchandise and prompt delivery time are important competitive factors for us, we maintain higher levels of inventory than our smaller competitors. For additional information regarding our cash, inventory and accounts receivable at the end of 2008 and 2007, see "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

Suppliers We purchase merchandise and raw materials from approximately 200 vendors dispersed throughout the United States and in approximately 15 foreign countries. In 2008, our ten largest vendors accounted for approximately 70% of our inventory purchases.

Because leather is sold internationally, market conditions abroad are likely to affect the price of leather in the United States. Outbreaks of mad cow and hoof-and-mouth disease (or foot-and-mouth disease) in any part of the world can influence the price of the leather we purchase. As such an occurrence is beyond our control, we cannot predict when and to what extent we could be affected in the future. Aside from increasing purchases when we anticipate price increases (or possibly delaying purchases if we foresee price declines), we do not attempt to hedge our inventory costs.

Overall, we believe that our relationships with suppliers are strong and do not anticipate any material changes in these supplier relationships. Due to the number of alternative sources of supply, the loss of any of these principal suppliers

would not have a material impact on our operations.

Operations Hours of operations vary by location, but generally range from 8:00 am to 6:00 pm Monday through Friday, and from 9:00 am to 4:00 pm on Saturdays. The stores maintain uniform prices, except where lower prices are necessary to meet local competition.

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Competition Most of our competition comes in the form of small, independently-owned retailers who in most cases are also our customers. We estimate that there are a few hundred of these small independent stores in the United States and Canada. We compete on price, availability of merchandise, and delivery time. While there is competition in connection with a number of our products, to our knowledge there is no direct competition affecting our entire product line. Our large size relative to most competitors gives us the advantage of being able to purchase large volumes and stock a full range of products.

Distribution The wholesale stores receive the majority of their inventory from our central warehouse located in Fort Worth, Texas, although occasionally, merchandise is shipped directly from the vendor. Inventory is shipped to the stores from our central warehouse once a week to meet customer demand without sacrificing inventory turns. Customer orders are filled as received, and we do not have backlogs.

We attempt to maintain the optimum number of items in our product line to minimize out-of-stock situations against carrying costs involved with such an inventory level. We generally maintain higher inventories of imported items to ensure a continuous supply. The number of products offered changes every year due to the introduction of new items and the discontinuance of others. We carry approximately 2,800 items in the current lines of leather and leather-related merchandise. All items are offered in all stores.

Expansion Our wholesale store expansion across the United States has been fairly consistent since we purchased the original six stores in 1985. We opened our thirtieth store in August 2002. We converted one wholesale (Leather Factory) store to a retail (Tandy Leather) store in 2006, reducing the number of wholesale stores to 29. We acquired Mid-Continent Leather Sales in 2007, a wholesale store located in Oklahoma, increasing the number of wholesale stores to 30. While we do not believe there is a significant and immediate opportunity for expansion of the Leather Factory distribution system in terms of opening additional locations, we do believe expansion could be achieved by acquiring companies in related areas/markets which offer collaborative advantages based on the local markets and/or the product lines of the businesses.

Retail Leathercraft

Our Retail Leathercraft division consists of a growing chain of retail stores operating under the name, Tandy Leather. Tandy Leather Company, established in 1919 as Hinkley-Tandy Leather Company, is the oldest and best-known supplier of leather and related supplies used in the leathercraft industry. We offer a product line of quality tools, leather, accessories, kits and teaching materials. This segment had net sales of \$25.2 million, \$24.7 million and \$22.5 million for 2008, 2007 and 2006, respectively.

General As of March 1, 2009, the Tandy Leather retail chain has 74 stores located in 35 states and five Canadian provinces with plans to reach 100 to 120 stores as opportunities arise over the next several years. The stores range in size from 1,200 square feet to 3,800 square feet, with the average size of a store being approximately 2,000 square feet. The type of premises utilized for a retail store is generally an older strip shopping center located at well-known crossroads, making the store easy to find.

Business Strategy Tandy Leather has long been known for its reputation in the leathercraft industry and its commitment to promoting and developing the craft through education and customer development. Our commitment to this strategy is evidenced by our re-establishment of the retail store chain throughout the United States following our acquisition of the assets of Tandy Leather in 2000. We continue to broaden our customer base by working with various youth organizations and institutions where people are introduced to leathercraft, as well as hosting classes in our stores.

The retail stores serve walk-in, mail and phone order customers as well as orders generated from our website, www.tandy-leatherfactory.com. Our retail stores are staffed by knowledgeable sales people whose compensation is based, in part, upon the profitability of their store. Sales by Tandy Leather are driven by the efforts of the store staff, trade shows, and our direct mail and e-mail marketing program.

Customers Individual retail customers are our largest customer group, representing more than 65% of Tandy Leather's 2008 sales. Youth groups, summer camps, schools and a limited number of wholesale customers complete our customer base. Like the wholesale stores, the retail stores fill orders as they are received, and there is no order backlog. The retail stores maintain reasonable amounts of inventory to fill these orders. Tandy Leather's retail store operations historically generate slightly more sales in the fourth quarter of each year (30-32%), while the other three quarters remain fairly even at 23-25% per quarter.

Merchandise Our products are generally organized into thirteen categories. We carry a wide assortment of products including leather, hand tools, kits, dyes & finishes and stamping tools. During 2008 and 2007, Retail Leathercraft division sales by product category were as follows:

| Product Category | 2008 Sales Mix | 2007 Sales Mix |
|-------------------------|----------------|----------------|
| Belts strips and straps | 4% | 4% |
| Books, patterns, videos | 3% | 3% |
| Buckles | 4% | 4% |
| Conchos | 4% | 4% |
| Craft supplies | 4% | 3% |
| Dyes, finishes, glues | 8% | 8% |
| Hand tools | 15% | 16% |
| Hardware | 6% | 6% |
| Kits | 11% | 11% |
| Lace | 4% | 4% |
| Leather | 31% | 31% |
| Stamping tools | 6% | 6% |
| | 100% | 100% |

As indicated above, the products sold in our retail stores are also sold in our wholesale stores. Therefore, the discussion above regarding products, their sources and the working capital requirements for the Wholesale Leathercraft division also apply to the Retail Leathercraft division. Sales at the retail stores are generally made through cash transactions or through national credit cards. We also sell on open account to selected wholesale customers including schools and other institutions and small retailers. Our terms are generally net 30 days. Like the wholesale stores, the retail stores have an unconditional return policy.

Operations Hours of operation are 9:00 am to 6:00 pm Monday through Friday, and from 9:00 am to 4:00 pm on Saturdays. In addition, most of the stores stay open late one night a week for leathercrafting classes taught in the stores. Selling prices are uniform throughout the retail store system.

Competition Our competitors are generally small local craft stores that carry a limited line of leathercraft products. Several national retail chains that are customers in our Wholesale Leathercraft division also carry leathercraft products on a very small scale relative to their overall product line. To our knowledge, our retail store chain is the only one in existence solely specializing in leathercraft.

Distribution The retail stores receive their inventory from our central warehouse located in Fort Worth, Texas. The stores generally restock their inventory once a week with a shipment from the warehouse. Retail Leathercraft's inventory turns are higher than Wholesale Leathercraft's because the Wholesale Leathercraft calculation includes the

central warehouse inventory whereas the Retail Leathercraft calculation includes only the inventory in the Tandy Leather retail stores.

Expansion We intend to expand the Tandy Leather retail store chain to between 100 and 120 stores throughout North America as it makes financial sense to do so. 14 stores were opened in 2002; 12 stores were opened in 2003; 16 were opened in 2004 (including four in Canada); eight were opened in 2005, 12 were opened in 2006, ten were opened in 2007 and one was opened in 2008. Of the 72 stores opened to date, 11 were independent leathercraft stores that we acquired. Separately, these acquisitions are not material. The other 62 stores have been de novo stores opened by us. In 2009, we plan to open four retail stores. We have already opened one and anticipate the remaining three to be opened in the middle to last half of the year.

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International Leathercraft

Our International Leathercraft division consists of company-owned stores located outside of North America. Currently, we have one wholesale and retail combination store located in Northampton, United Kingdom, which we opened in February 2008. It operates under the Tandy Leather Factory trade name. This segment had net sales of \$836,000 in 2008.

Business Strategy The business concept for our International Leathercraft division is a blending of our Leather Factory and Tandy Leather business strategies – the wholesale distribution of leather and related accessories to retailers, manufacturers and other businesses, as well as the promotion and continuance of leathercraft through education and development of the retail customers. The store is located in a 6,600 square foot building in a light industrial area. We maintain sufficient inventory so that our customers can purchase the leather, related accessories and supplies necessary to complete their projects from one supplier. The layout of the store is such that large quantities of product can be displayed in an easily accessible and visually appealing manner. The store services walk-in, mail and phone order customers as well as orders generated from its website, www.tandy-leatherfactory.co.uk. Sales are driven by the efforts of the store staff, trade shows, and our direct mail and e-mail marketing programs.

Customers The growing customer base consists of individuals, wholesale distributors, equine-related shops, cobblers, dealers, and retailers dispersed geographically throughout the UK and Europe. Retail sales generally occur via cash transactions or through national credits cards. We also sell on open account to selected wholesale customers including dealers, manufacturers, and retailers. Like our USA stores, our UK store has an unconditional return policy.

Merchandise The products sold in our UK store are also sold in our USA stores. Therefore, the discussion above regarding products, their sources and the working capital requirements for the Wholesale and Retail Leathercraft divisions also apply here.

Operations Hours of operation are 8:00 am to 5:00 pm Monday through Friday, and from 8:00 am to 2:00 pm on Saturdays. Selling prices are consistent with the USA store pricing, adjusted for currency fluctuation.

Distribution The UK store receives the majority of its inventory from our central warehouse located in Fort Worth, Texas, although occasionally, merchandise is shipped directly from the vendor. Inventory is shipped from our warehouse to the store several times per month to meet customer demand without sacrificing inventory turns. Customer orders are filled as received, and we do not have backlogs.

Expansion We intend to expand further internationally although have no specific plans or time frame at this time. We will continue to grow our customer base throughout Europe as well as other parts of the world so that we can support additional stores.

Other

Roberts, Cushman, founded in 1856, supplies made-to-order trimmings to the headwear industry. This segment had net sales of \$745,000, \$1.1 million, and \$1.7 million for 2008, 2007 and 2006, respectively. This segment is immaterial to our overall business strategy.

For more information about our business and our reportable segments, see Item 7 “Management’s Discussion and Analysis of Financial Condition and Results of Operations” on page 8.

Additional Information

Compliance With Environmental Laws Our compliance with federal, state and local environmental protection laws has not had, and is not expected to have, a material effect on our capital expenditures, earnings or competitive position.

Employees As of December 31, 2008, we employed 458 people, 367 of whom were employed on a full-time basis. We are not a party to any collective bargaining agreements. Overall, we believe that relations with employees are good.

Intellectual Property We own approximately 20 registered trademarks, including federal trade name registrations for "The Leather Factory" and "Tandy Leather Company." We also own approximately 20 registered foreign trademarks worldwide.

We own approximately 500 registered copyrights in the United States covering more than 600 individual works relating to various products. We also own several United States patents for specific belt buckles and leather-working equipment. These rights are valuable assets, and we defend them as necessary.

International Operations Information regarding our revenues from the United States and abroad and our long-lived assets are found in Note 14 to our Consolidated Financial Statements, Segment Information.

Our Website and Availability of SEC Reports We file reports with the Securities and Exchange Commission ("SEC"). These reports include our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to these filings. The public may read any of these filings at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. In addition, the public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Further, the SEC maintains an Internet site that contains reports, proxy and information statements and other information concerning us. You can connect to this site at <http://www.sec.gov>.

Our corporate website is located at <http://www.tandyleatherfactory.com>. We make copies of our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, proxy statements and any amendments filed with or furnished to the SEC available to investors on or through our website free of charge as soon as reasonably practicable after we electronically file them with or furnish them to the SEC. Our SEC filings can be found on the Investor Relations page of our website through the "SEC Filings" link. In addition, certain other corporate governance documents are available on this website through the "Corporate Governance" link.

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Executive Officers of the Registrant

The following table sets forth information concerning our executive officers as of March 27, 2009:

| Name and Age | Position and Business Experience During Past Five Years | Served as Officer Since |
|-----------------------|---|-------------------------|
| J. Wray Thompson, 77 | Chairman of the Board since June 1993; Chief Executive Officer from June 1993 to December 2006 | 1993 |
| Ronald C. Morgan, 61 | Chief Executive Officer since January 2007; President since January 2001; Chief Operating Officer since June 1993 | 1993 |
| Jon W. Thompson, 47 | President since June 2008; Senior Vice President since June 1993 | 2008 |
| Shannon L. Greene, 43 | Chief Financial Officer since May 2000 | 2000 |
| Mark J. Angus, 48 | Senior Vice President since June 2008; Vice President of Merchandising since June 1993 | 2008 |
| Robin L. Morgan, 58 | Vice President of Administration since June 1993 | 1993 |

Wray Thompson has served as our Chairman of the Board since June 1993. He served as Chief Executive Officer from June 1993 to December 2006. He also served as President from June 1993 to January 2001. Mr. Thompson was a co-founder of the company.

Ronald C. Morgan has served as our Chief Executive Officer since January 2007. He has also served as President and Chief Operating Officer from January 2001 to June 2008 and director since June 1993. Mr. Morgan was also a co-founder of the company. Mr. Morgan is married to Robin L. Morgan, our Vice President.

Jon W. Thompson has served as President and Chief Operating Officer since June 2008, following the resignation of Ron Morgan. He served as Senior Vice President from June 1993 to June 2008. Mr. Thompson is the son of Wray Thompson, Chairman of the Board.

Shannon L. Greene has served as our Chief Financial Officer and Treasurer since May 2000 and director since January 2001. Ms. Greene is also our Chief Accounting Officer. Ms. Greene, a certified public accountant, also serves on our 401(k) Plan committee. Her professional affiliations include the American Institute of Certified Public Accountants, the Texas Society of Certified Public Accountants and its Fort Worth chapter, the Fort Worth Association for Financial Professionals, and the Financial Executives International. She also sits on the Board of Directors of the U.S. Chamber of Commerce.

Mark J. Angus has served as Senior Vice President since June 2008, following Jon Thompson's resignation. He served as Vice President of Merchandising since January 1993.

Robin L. Morgan has served as our Vice President of Administration and Assistant Secretary since June 1993. She serves as chairman of our 401(k) Plan committee. Ms. Morgan is married to Ronald C. Morgan, our CEO.

All officers are elected annually by the Board of Directors to serve for the ensuing year.

ITEM 1A. RISK FACTORS

You should carefully consider the following risk factors together with all of the other information included in this annual report, including the financial statements and related notes, when deciding to invest in us. You should be aware that the occurrence of any of the events described in this Risk Factors section and elsewhere in this annual report could have a material adverse effect on our business, financial position, results of operations and cash flows. Some, but not all, of the important risks which could cause actual results to differ materially from those suggested by forward-looking statements made by us include the following:

- We might fail to realize the anticipated benefits of the opening of Tandy Leather retail stores or we might be unable to obtain sufficient new locations on acceptable terms to meet our growth plans. Further, we might fail to hire and train competent managers to oversee the stores opened.
- 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. Also, hostilities, terrorism or other events could worsen this condition.
- 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.
- Political considerations here and abroad could disrupt our sources of supplies from abroad or affect the prices we pay for goods.
- Continued involvement by the United States in war and other military operations in the Middle East and other areas abroad could disrupt international trade and affect our inventory sources.
- As a result of the on-going threat of terrorist attacks on the United States, consumer buying habits could change and decrease our sales.
- Livestock diseases such as mad cow could reduce the availability of hides and leathers or increase their cost. Also, the prices of hides and leathers fluctuate in normal times, and these fluctuations can affect us.
- If, for whatever reason, the costs of our raw materials and inventory increase, we may not be able to pass those costs on to our customers.
- Other factors could cause either fluctuations in buying patterns or possible negative trends in the craft and western retail markets. In addition, our customers may change their preferences to products other than ours, or they may not accept new products as we introduce them.
- Any change in the commercial banking environment may affect us and our ability to borrow capital as needed.

Other uncertainties, which are difficult to predict and many of which are beyond our control, may occur as well.

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ITEM 2. PROPERTIES

We lease all of our store locations premises, with the majority of our stores having initial lease terms of approximately five years. The leases are generally renewable, with increases in lease rental rates in some cases. We believe that all of our properties are adequately covered by insurance. The properties leased by our Wholesale Leathercraft (Leather Factory stores), Retail Leathercraft (Tandy Leather stores), and International Leathercraft divisions are described in Item 1 in the description of each segment. We also lease a 284 square-foot showroom in the Denver Merchandise Mart for \$5,908 per year. This lease will expire in October 2011.

We own our corporate headquarters, which includes our central warehouse and manufacturing facility, the sales, advertising, administrative, and executive offices, and the administrative offices of Roberts, Cushman. The facility consists of 191,000 square feet located on approximately 30 acres.

The following table summarizes the locations of our leased premises as of December 31, 2008:

| State | Wholesale Leathercraft | Retail Leathercraft | International |
|----------------|------------------------|---------------------|---------------|
| Alabama | - | 1 | - |
| Alaska | - | 1 | - |
| Arizona | 2 | 2 | - |
| Arkansas | - | 1 | - |
| California | 3 | 7 | - |
| Colorado | 1 | 3 | - |
| Connecticut | - | 1 | - |
| Florida | 1 | 3 | - |
| Georgia | - | 1 | - |
| Idaho | - | 1 | - |
| Illinois | 1 | 1 | - |
| Indiana | - | 2 | - |
| Iowa | 1 | - | - |
| Kansas | 1 | - | - |
| Kentucky | - | 1 | - |
| Louisiana | 1 | - | - |
| Maryland | - | 1 | - |
| Massachusetts | - | 1 | - |
| Michigan | 1 | 1 | - |
| Minnesota | - | 2 | - |
| Missouri | 1 | 2 | - |
| Montana | 1 | - | - |
| Nebraska | - | 1 | - |
| Nevada | - | 2 | - |
| New Mexico | 1 | 2 | - |
| New York | - | 1 | - |
| North Carolina | - | 2 | - |
| Ohio | 1 | 2 | - |
| Oklahoma | 1 | 2 | - |
| Oregon | 1 | - | - |
| Pennsylvania | 1 | 2 | - |
| South Carolina | - | 1 | - |
| South Dakota | - | 1 | - |
| Tennessee | 1 | 3 | - |

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| | | | |
|--------------------------|---|---|---|
| Texas | 5 | 9 | - |
| Utah | 1 | 2 | - |
| Virginia | - | 1 | - |
| Washington | 1 | 2 | - |
| Wisconsin | - | 1 | - |
| Wyoming | - | 1 | - |
| Canadian locations: | | | |
| Alberta | 1 | 1 | - |
| British Columbia | - | 1 | - |
| Manitoba | 1 | - | - |
| Nova Scotia | - | 1 | - |
| Ontario | 1 | 2 | - |
| Quebec | - | 1 | - |
| International locations: | | | |
| United Kingdom | - | - | 1 |

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ITEM 3. LEGAL PROCEEDINGS

We are involved in litigation in the ordinary course of business but are not currently a party to any material pending legal proceedings.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no matters submitted to a vote of our security holders during the fourth quarter of our fiscal year ended December 31, 2008.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Our common stock is traded on the NYSE Amex using the symbol "TLF". The high and low trading prices for each calendar quarter during the last two fiscal years are as follows:

| 2008 | High | Low | 2007 | High | Low |
|-------------|--------|--------|-------------|--------|--------|
| 4th quarter | \$2.75 | \$1.72 | 4th quarter | \$7.15 | \$2.70 |
| 3rd quarter | \$3.07 | \$2.49 | 3rd quarter | \$7.55 | \$5.80 |
| 2nd quarter | \$3.37 | \$2.63 | 2nd quarter | \$7.50 | \$6.85 |
| 1st quarter | \$3.32 | \$2.30 | 1st quarter | \$8.25 | \$6.81 |

There were approximately 526 stockholders of record on March 1, 2009.

We have never declared or paid any cash dividends on the shares of our common stock. Our Board of Directors has historically followed a policy of reinvesting our earnings in the expansion of our business. This policy is subject to change based on future industry and market conditions, as well as other factors.

We did not sell any shares of our equity securities during our fiscal year ended December 31, 2008 that were not registered under the Securities Act.

The following table provides information about purchases we have made of our common stock during the quarter ended December 31, 2008:

ISSUER PURCHASES OF EQUITY SECURITIES

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|--------------------------------|--------------------------------------|----------------------------------|--|--|
| October 1 through October 31 | 194,610 | \$2.67 | 194,610 | 292,180 |
| November 1 through November 30 | 73,332 | \$2.35 | 73,332 | 218,848 |
| December 1 through December 31 | 56,595 | \$1.96 | 56,595 | -0- |
| Total | 324,537(1) | \$2.47 | 324,537 | -0- |

- (1) On September 9, 2008, our Board of Directors approved a limited stock repurchase plan whereby all non-officer participants in The Leather Factory, Inc. Stock Ownership Plan (the “ESOP”) would have the option of selling the shares of our common stock distributed to them upon termination of the ESOP back to us. The option remained open to the non-officer participants for a period of sixty days beginning on September 26, 2008 and ending on November 25, 2008. The purchase price of the shares was calculated at a price-per-share equal to the closing price of a share of our common stock on the American Stock Exchange on the business day each non-officer participant notified the ESOP administrator of his or her intent to sell his or her shares to us. All of the 324,537 shares we repurchased between October 1 and December 31, 2008 were repurchased in connection with the termination of the ESOP.

Stockholder Return Performance Graph

The line graph below compares the yearly percentage change in our cumulative five-year total stockholder return on our common stock with the Standard & Poor’s SmallCap 600 Index and the S&P Specialty Stores Index. The graph assumes that \$100 was invested on December 31, 2003 in our common stock, the Standard & Poor’s SmallCap 600 Index, and the S&P Specialty Stores Index, and that all dividends were reinvested. The returns shown on the graph are not necessarily indicative of future performance.

COMPARISON OF FIVE-YEAR CUMULATIVE TOTAL RETURNS Tandy Leather Factory, Inc.

| Company Name / Index | Dec 03 | Dec 04 | Dec 05 | Dec 06 | Dec 07 | Dec 08 |
|------------------------|--------|--------|--------|--------|--------|--------|
| TANDY LEATHER FACTORY | 100 | 73.35 | 141.53 | 166.74 | 67.56 | 44.42 |
| S&P SMALLCAP 600 INDEX | 100 | 122.65 | 132.07 | 152.04 | 151.58 | 104.48 |
| S&P SPECIALTY STORES | 100 | 105.20 | 124.25 | 151.04 | 110.87 | 70.30 |

Data Source: Research Data Group, Inc., San Francisco, CA

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ITEM 6. SELECTED FINANCIAL DATA

The selected financial data presented below are derived from and should be read in conjunction with our Consolidated Financial Statements and related notes. This information should also be read in conjunction with "Item 7 - Management's Discussion and Analysis of Financial Condition and Results of Operations." Data in prior years has not been restated to reflect acquisitions, if any, that occurred in subsequent years.

Income Statement Data,

| Years ended December 31, | 2008 | 2007 | 2006 | 2005 | 2004 |
|---|--------------|--------------|--------------|--------------|--------------|
| Net sales | \$53,237,094 | \$55,317,002 | \$55,199,021 | \$50,719,574 | \$46,146,284 |
| Cost of sales | 21,857,800 | 23,644,599 | 23,566,251 | 21,964,530 | 20,706,239 |
| Gross profit | 31,379,294 | 31,672,403 | 31,632,770 | 28,755,044 | 25,440,045 |
| Operating expenses | 27,200,150 | 27,161,402 | 24,565,056 | 23,181,633 | 21,181,599 |
| Operating income | 4,179,144 | 4,511,001 | 7,067,714 | 5,573,411 | 4,258,446 |
| Operating income per share - basic | \$0.38 | \$0.41 | \$0.65 | \$0.52 | \$0.40 |
| Operating income per shares - diluted | \$0.38 | \$0.40 | \$0.64 | \$0.51 | \$0.39 |
| Other (income) expense | 67,072 | (316,831) | (98,391) | (134,502) | 44,800 |
| Income (loss) before income taxes | 4,112,072 | 4,827,832 | 7,166,105 | 5,707,913 | 4,213,646 |
| Income tax provision (benefit) | 1,507,891 | 1,739,701 | 2,389,039 | 1,994,199 | 1,559,605 |
| Net income (loss) | \$2,604,181 | \$3,088,131 | \$4,777,066 | \$3,713,714 | \$2,654,041 |
| Earnings (loss) per share | \$0.24 | \$0.28 | \$0.44 | \$0.35 | \$0.25 |
| Earnings (loss) per share-assuming dilution | \$0.24 | \$0.28 | \$0.43 | \$0.34 | \$0.24 |
| Weighted average common shares outstanding for: | | | | | |
| Basic EPS | 10,931,306 | 10,951,481 | 10,643,004 | 10,643,004 | 10,543,994 |
| Diluted EPS | 11,015,657 | 11,157,775 | 10,976,240 | 10,976,240 | 10,957,518 |

Balance Sheet Data, as of December 31,

| | 2008 | 2007 | 2006 | 2005 | 2004 |
|---|--------------|--------------|--------------|--------------|--------------|
| Cash and certificates of deposit | \$10,821,298 | \$6,810,396 | \$6,739,981 | \$3,215,727 | \$2,560,202 |
| Total assets | 40,975,913 | 37,651,506 | 31,916,635 | 25,680,473 | 22,167,163 |
| Capital lease obligation, including current portion | 593,949 | - | 111,723 | 245,789 | 379,857 |
| Long-term debt, including current portion | 3,915,000 | 4,050,000 | - | - | 505,154 |
| Total Stockholders' Equity | \$31,264,762 | \$29,815,504 | \$26,323,243 | \$21,257,857 | \$17,310,233 |

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

We intend for the following discussion to provide you with information that will assist you in understanding our financial statements, the changes in key items in those financial statements from year to year and the primary factors that accounted for those changes, as well as how particular accounting principles affect our financial statements. This discussion also provides information about the financial results of the various segments of our business so you may better understand how those segments and their results affect our financial condition and results of operations as a whole. Finally, we have identified and discussed trends known to management that we believe are likely to have a material effect.

This discussion should be read in conjunction with our financial statements as of December 31, 2008 and 2007 and the two years then ended and the notes accompanying those financial statements. You are also urged to consider the information under the caption "Summary of Critical Accounting Policies."

Summary

We are the world's largest specialty retailer and wholesale distributor of leather and leathercraft-related items. Our operations are centered on operating retail and wholesale stores. We have built our business by offering our customers quality products in one location at competitive prices. The key to our success is our ability to grow our base business. We grow that business by opening new locations and by increasing sales in our existing locations. We intend to continue to expand both domestically, in the short-term, and internationally, in the long-term.

We operate in four segments. First, Wholesale Leathercraft, consisting of our Leather Factory stores and our national account group, is the largest source of our revenues (\$26.4 million in 2008). This division has generally offered steady but modest increases in sales. Sales in 2008 declined 10.6%. The wholesale stores' sales declined 10% compared to 2007 and national account sales were down 12%. Much of the sales decline at the stores is attributed to an overall weakness in consumer spending, which results in fewer purchases of our products by small businesses. The decline in national account sales is related to weaker consumer spending as well as the expected decline in sales to one customer who stopped purchasing from us in the first quarter of 2008.

Since acquiring its assets in 2000, we have focused on re-establishing Tandy Leather as the operator of retail leathercraft stores. These retail stores comprise our second segment, Retail Leathercraft. Because of growth here, this segment has experienced the greatest increases in sales (\$25.2 million in 2008, up from \$24.6 million in 2007). Our business plan calls for opening an average of 10-12 stores annually as we work toward a goal of 100+ stores from 73 stores at the end of 2008. We have slowed down our new store openings in recent years due to the general economic conditions in the U.S. We plan to open 4 new stores in 2009, one of which was opened in the first quarter.

Our third segment is International Leathercraft, which consists of stores located outside of North America. Currently, we have one retail/wholesale combination store located in the United Kingdom, which was opened in February 2008. It is our intention to add more stores to this segment once we have a large enough customer base to support additional stores.

We refer to our fourth segment as "Other". It consists of Roberts, Cushman, a supplier of trimmings for headwear. Its operations are not material to us.

On a consolidated basis, a key indicator of costs, gross margin as a percent of total net sales, held steady in 2007 and increased in 2008. Operating expenses as a percent of total net sales in 2008 increased 2.0% from 2007. Operating expenses increased 4.6% as a percentage of total net sales in 2007 when compared with 2006. The increase in operating expenses in 2007 was due to our delayed response to cut expenses on weaker than expected sales, particularly in the second and third quarters. We were much more successful in our control of operating expenses in 2008, given the continued weak sales environment.

We reported consolidated net income for 2008 of \$2.6 million. Consolidated net income for 2007 and 2006 was \$3.1 million and \$4.8 million, respectively. We have used our cash flow to fund our operations, to fund the opening of new Tandy Leather stores, to purchase necessary property and equipment and make acquisitions of small competitors in the retail and wholesale market. In 2007, we incurred \$4.0 million in bank debt to purchase a 191,000 square foot building to house our corporate headquarters and central support units. We moved into that facility in the first quarter of 2008. At the end of 2009, our stockholders' equity had increased to \$31.3 million from \$29.8 million the previous year.

Comparing the December 31, 2008 balance sheet with the prior year's balance sheet, we reduced our investment in inventory from \$17.5 million to \$16.0 million, while total cash (including certificates of deposit and other short-term investments) increased from \$6.8 million from \$10.8 million.

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Net Sales

Net sales for the three years ended December 31, 2008 were as follows:

| Year | Wholesale Leathercraft | Retail Leathercraft | International Leathercraft | Other | Total Company | Incr (Decr) from Prior Year |
|------|---------------------------|------------------------|-------------------------------|---------------|---------------|--------------------------------|
| 2008 | \$26,423,858 | \$25,231,145 | \$836,535 | \$745,556 | \$53,237,094 | (3.8)% |
| 2007 | \$29,555,978 | \$24,663,750 | | - \$1,097,274 | \$55,317,002 | 0.2% |
| 2006 | \$31,068,188 | \$22,520,461 | | - \$1,610,372 | \$55,199,021 | 8.8% |

Our net sales fell by 3.8% in 2008 when compared with 2007 and grew by 0.2% in 2007 when compared with 2006. The 2008 sales decline resulted primarily from our Wholesale Leathercraft segment, offset somewhat by an increase in Retail Leathercraft sales and the sales from our new International Leathercraft segment, although sales at our retail stores have slowed down somewhat due to an overall slowdown in consumer spending in 2007 and 2008. The reduction in sales in our wholesale stores is also the result of the overall economic slowdown in the U.S.

Costs and Expenses

In general, our gross profit as a percentage of sales (our gross margin) fluctuates based on the mix of customers we serve, the mix of products we sell and our ability to source products globally. Our negotiations with suppliers for lower pricing are an on-going process, and we have varying degrees of success in those endeavors. Sales to retail customers tend to produce higher gross margins than sales to wholesale customers due to the difference in pricing levels. Therefore, as retail sales increase in the overall sales mix, higher gross margins tend to follow. Finally, there is significant fluctuation in gross margins between the various merchandise categories we offer. As a result, our gross margins can vary depending on the mix of products sold during any given time period.

For 2008, our cost of sales decreased as a percentage of total net sales when compared to 2007, resulting in an increase in consolidated gross profit margin from 57.3% to 58.9%. Our total cost of sales as a percentage of our total net sales held steady from 2006 to 2007, resulting in a consolidated gross profit margin at 57.3% in both years. Increases in gross margin are primarily due to increased retail sales from year to year.

Our gross margins for the three years ended December 31, 2008 were as follows:

| Year | Wholesale Leathercraft | Retail Leathercraft | International Leathercraft | Other | Total Company |
|------|---------------------------|------------------------|-------------------------------|-------|---------------|
| 2008 | 56.5% | 61.6% | 68.4% | 44.1% | 58.9% |
| 2007 | 55.7% | 59.7% | - | 44.8% | 57.3% |
| 2006 | 56.1% | 60.8% | - | 32.1% | 57.3% |

Our operating expenses increased 2.0% as a percentage of total net sales to 51.1% in 2008 when compared with 49.1% in 2007. This increase indicates that our operating expenses grew faster than our sales during this period. However, 2008 operating expenses were only \$38,000 higher than those of 2007. Significant expense fluctuations in 2008 compared to 2007 are as follows:

| Expense | 2008 amount | Incr (decr) over 2007 |
|----------------------------------|----------------|-----------------------|
| Employee compensation & benefits | \$14.0 million | \$(160,000) |
| Rent & utilities | 4.1 million | 323,000 |
| Depreciation and amortization | 985,000 | 350,000 |
| Advertising | 3.0 million | (400,000) |
| | 1.5 million | (140,000) |

Freight out – shipping product to customers

| | | |
|------------------|---------|-----------|
| Property taxes | 260,000 | 135,000 |
| Outside services | 260,000 | (240,000) |

Our operating expenses increased 4.6% as a percentage of total net sales to 49.1% in 2007 when compared with 44.5% in 2006. Significant expense fluctuations in 2007 compared to 2006 are as follows:

| Expense | 2007 amount | Incr (decr) over 2006 |
|----------------------------------|----------------|-----------------------|
| Employee compensation & benefits | \$14.1 million | \$800,000 |
| Rent & utilities | 3.8 million | 300,000 |
| Depreciation and amortization | 635,000 | 240,000 |
| Advertising | 3.4 million | 400,000 |
| Legal & professional fees | 650,000 | 350,000 |

Other Income/Expense (net)

Other Income/Expense consists primarily of currency exchange fluctuations, interest income and interest expense. In 2008, we had other expense (net) of \$67,000 compared to other income (net) of \$317,000 in 2007. We received \$230,000 for surface damage and additional access related to the oil and gas lease associated with a portion of the land surrounding our corporate facility. We earned \$141,000 in interest income on our cash and paid \$332,000 in interest expense on our bank debt. We had a currency exchange loss of \$114,000 in 2008 compared to income of \$9,000 in 2007.

In 2007, we had other income (net) of \$317,000 compared to other income (net) of \$98,000 in 2006. We received rental income of \$150,000 from our new building as we leased the building to the sellers for 90 days after purchase. We also received \$100,000 as a signing bonus on an oil and gas lease we signed related to a portion of the land we purchased. We earned \$140,000 in interest income on our cash and paid \$122,000 in interest expense on our bank debt. We had a currency exchange gain of \$9,000 in 2007 compared to \$52,000 in 2006.

Net Income

During 2008, we earned net income of \$2.6 million, a 16% decline over our net income of \$3.1 million earned during 2007. The decline in net income was the result of the decrease in gross profit and the decrease in other income, partially offset by the reduction in income tax expense.

During 2007, we earned net income of \$3.1 million, a 35% decline from our net income of \$4.8 million earned during 2006. The decline in net income was the result of the increase in operating expenses at a higher rate than that of our sales, partially offset by the reduction in income tax expense.

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Wholesale Leathercraft

The increases in net sales, operating income, operating income increases (or decreases) and operating income as a percentage of sales from our Wholesale Leathercraft stores for the three years ended December 31, 2008 were as follows:

| Year | Net Sales Incr (Decr) from Prior Yr | Operating Income | Operating Income Incr (Decr) from Prior Year | Operating Income as a Percentage of Sales |
|------|-------------------------------------|------------------|--|---|
| 2008 | (10.6)% | \$1,842,526 | (34.8)% | 6.9% |
| 2007 | (3.7)% | \$2,826,710 | (41.3)% | 9.6% |
| 2006 | (0.1)% | \$4,814,240 | 29.4% | 15.5% |

Wholesale Leathercraft, consisting of our 30 wholesale stores and our national account group, accounted for 49.6% of our consolidated net sales in 2008, which compares to 53.4% in 2007 and 56.2% in 2006. The decrease in this division's contribution to our total net sales is the result of the growth in Retail Leathercraft and we expect this trend to continue.

Sales in the wholesale stores decreased 10.4% in 2008 compared to sales in 2007 while the sales decline in our national account group was 12.2%. By customer group, we had sales declines in all groups. The most significant decreases were in our wholesale and manufacturer groups. The customers of these groups are small businesses and have been significantly affected by the weakness in our economy. Our sales mix by customer group in the Wholesale Leathercraft division was as follows:

| Customer Group | 2008 | 2007 | 2006 |
|-------------------|------|------|------|
| Retail | 26% | 23% | 25% |
| Institution | 8% | 8% | 7% |
| Wholesale | 41% | 42% | 39% |
| National Accounts | 17% | 15% | 19% |
| Manufacturers | 8% | 12% | 10% |
| | 100% | 100% | 100% |

The 2008 decrease in operating income as a percentage of divisional sales resulted from a decrease of 9.2% in gross margin (as a percentage of sales) compared with 2007, offset partially by a decrease of 3.9% in operating expenses as a percent of sales. Significant operating expense decreases occurred in employee compensation and benefits (\$670,000), outside services (\$235,000) and freight out (\$200,000). These decreases were partially offset by increases in depreciation expense (\$400,000) and property taxes (\$230,000), both due to the purchase of our corporate facility.

The 2007 increase in operating income as a percentage of divisional sales resulted from a decrease of 0.6% in gross margin (as a percentage of sales) compared with 2006, and an increase of 6.6% in operating expenses as a percent of sales. Significant operating expense increases occurred in employee compensation and benefits (\$500,000), depreciation expense (\$200,000), legal and professional fees (\$300,000) and advertising costs (\$200,000). These increases were partially offset by decreases in various insurance expenses (\$100,000) and general supplies (\$75,000).

Retail Leathercraft

The increases in net sales, operating income, operating income increases (or decreases) and operating income as a percentage of sales from our Retail Leathercraft stores for the three years ended December 31, 2008 were as follows:

| Year | Operating | Operating Income |
|------|-----------|------------------|
|------|-----------|------------------|

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| | Net Sales Increase from Prior Yr | Income | Incr (Decr) from Prior Year | Operating Income as a Percentage of Sales |
|------|--|-------------|--------------------------------|---|
| 2008 | 2.3% | \$2,188,282 | 41.7% | 8.7% |
| 2007 | 9.5% | \$1,544,320 | (33.2)% | 6.3% |
| 2006 | 25.0% | \$2,310,073 | 30.7% | 10.3% |

Reflecting the growth previously discussed, Retail Leathercraft accounted for 47.4% of our total net sales in 2008, up from 44.6% in 2007 and 40.8% in 2006.

Growth in net sales for Retail Leathercraft division in 2008 and 2007 resulted primarily from our expansion program. Expansion during 2008 and 2007 consisted of the opening of 1 and 10 new stores, respectively.

Our sales mix by customer group in the Retail Leathercraft division was as follows:

| Customer Group | 2008 | 2007 | 2006 |
|-------------------|------|------|------|
| Retail | 65% | 63% | 65% |
| Institution | 9% | 8% | 8% |
| Wholesale | 25% | 27% | 26% |
| National Accounts | 0% | 0% | 0% |
| Manufacturers | 1% | 2% | 1% |
| | 100% | 100% | 100% |

Operating income as a percentage of sales increased to 8.7% for 2008 compared to 6.3% for 2007. Gross margin improved to 61.6% in 2008 from 59.7% in 2007. Operating expenses as a percent of sales in 2008 decreased by 0.6%, from 53.5% for 2007 to 52.9% for 2008 as operating expenses grew at a slower pace than that of sales and gross margin.

Operating income as a percentage of sales decreased to 6.3% for 2007 compared to 10.3% for 2006. Gross margin fell to 59.7% in 2007 from 60.8% in 2006. Operating expenses as a percent of sales in 2007 decreased by 3.0%, from 50.5% for 2006 to 53.5% for 2007 as operating expenses grew at a faster pace than that of sales and gross margin.

We intend to continue the expansion of Tandy Leather's retail store chain in 2009 by opening approximately 4 new stores, one of which was opened in the first quarter. We remain committed to a conservative expansion plan for this division that minimizes risks to our profits and maintains financial stability. In the current economic environment in the U.S., it is possible that we will change our plans for store openings in 2009 if we determine that the U.S. retail sector can not support additional store openings at that time.

International Leathercraft

International Leathercraft consists of all stores located outside of North America. Currently, that represents one retail/wholesale combination store located in the United Kingdom. International Leathercraft accounted for 1.6% of our total sales in 2008. Operating income was \$54,000 in 2008. We expect this segment to become a larger part of our total operations as time progresses.

Other

Roberts, Cushman accounted for 1.4% of our total sales in 2008 compared with 2.0% and 2.9% in 2007 and 2006, respectively. Operating income was \$94,000 in 2008 compared to operating income of \$140,000 in 2007 and an operating loss of \$57,000 in 2006. Roberts, Cushman's sales and profits are immaterial to us as a whole.

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Financial Condition

At December 31, 2008, we held \$10.8 million of cash and certificates of deposit, \$16.0 million of inventory, accounts receivable of \$1.2 million, and \$10.3 million of property and equipment. Goodwill and other intangibles (net of amortization and depreciation) were \$966,000 and \$355,000, respectively. Net total assets were \$40.9 million. Current liabilities were \$5.1 million (including \$468,000 of current maturities of long-term debt), while long-term debt was \$4.0 million. Total stockholders' equity at the end of 2008 was \$31.2 million.

At December 31, 2007, we held \$6.8 million of cash, \$17.5 million of inventory, accounts receivable of \$2.5 million, and \$7.0 million of property and equipment. Goodwill and other intangibles (net of amortization and depreciation) were \$990,000 and \$384,000, respectively. Net total assets were \$37.6 million. Current liabilities were \$3.8 million (including \$135,000 of current maturities of long-term debt), while long-term debt was \$3.9 million. Total stockholders' equity at the end of 2007 was \$29.8 million.

Specific ratios on a consolidated basis at the end of each year ended December 31 were as follows:

| | | 2008 | 2007 | 2006 |
|--|--|-------|-------|-------|
| Solvency Ratios: | | | | |
| Quick Ratio | Cash+Accts Rec/Total Current Liabilities | 2.37 | 2.48 | 1.74 |
| Current Ratio | Total Current Assets/Total Current Liabilities | 5.72 | 7.47 | 5.19 |
| Current Liabilities to Net Worth | Total Current Liabilities/Net Worth | 0.16 | 0.13 | 0.20 |
| Current Liabilities to Inventory | Total Current Liabilities/Inventory | 0.32 | 0.22 | 0.31 |
| Total Liabilities to Net Worth | Total Liabilities/Net Worth | 0.31 | 0.26 | 0.21 |
| Fixed Assets to Net Worth | Fixed Assets/Net Worth | 0.33 | 0.23 | 0.07 |
| Efficiency Ratios: | | | | |
| Collection Period (Days Outstanding) | Accounts Receivable/Credit Sales x 365 | 54.89 | 63.42 | 53.43 |
| Inventory Turnover | Sales/Average Inventory | 3.18 | 3.19 | 3.36 |
| Assets to Sales | Total Assets/Sales | 0.77 | 0.68 | 0.58 |
| Sales to Net Working Capital | Sales/Current Assets - Current Liabilities | 2.22 | 2.27 | 2.45 |
| Accounts Payable to Sales | Accounts Payable/Sales | 0.02 | 0.03 | 0.03 |
| Profitability Ratios: | | | | |
| Return on Sales (Profit Margin) | Net Profit After Taxes/Sales | 0.05 | 0.06 | 0.09 |
| Return on Assets | Net Profit After Taxes/Total Assets | 0.06 | 0.08 | 0.15 |
| Return on Net Worth (Return on Equity) | Net Profit After Taxes/Net Worth | 0.08 | 0.10 | 0.18 |

Capital Resources and Liquidity

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 and remodel 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 initial purchase of the property. On April 30, 2008, that amount was rolled into a ten-year term note, and we began making monthly debt service payments in May 2008.

We are currently in compliance with all covenants and conditions contained in the JPMorgan Chase Credit Agreement and have no reason to believe that we will not continue to operate in compliance with the provisions of these financing arrangements. The principal terms and conditions of the Credit Agreement are described in further detail in Note 6 to the Consolidated Financial Statements, Notes Payable and Long-Term Debt.

Reflecting the borrowing and reduction of bank indebtedness during the periods, our financing activities for 2008, 2007 and 2006 provided (required) net cash of \$1.1 million, \$4.0 million, and \$69,000, respectively.

Our primary source of liquidity and capital resources during 2008 was cash flow provided by operating activities. Cash flow from operations for 2008 and 2007 was \$7.8 million and \$2.5 million, respectively, the largest portion being generated from net income. This net income was partially offset by the decrease in accrued expenses in 2007 and the decrease of accounts receivable and inventory in 2008. Cash flow from operations in 2006 was \$3.9 million.

Consolidated accounts receivable decreased significantly to \$1.2 million at December 31, 2008 compared to \$2.5 million at December 31, 2007. Average days to collect accounts improved from 63.4 days in 2007 to 54.9 days in 2008 on a consolidated basis. As evidenced by the significant reduction in our accounts receivable at the end of 2008, we have tightened our credit policy and are aggressively monitoring our customer accounts to ensure collectibility. We believe the trend in our collections is the result of the overall slowdown in the U.S. economy. Many of our customers with open accounts are very small businesses, and they tend to feel the effects of an economic slowdown more severely than larger businesses.

Inventory decreased from \$17.5 million at the end of 2007 to \$16.0 million at December 31, 2008. We expect our inventory to slowly trend upward as we continue our expansion of the Tandy Leather store chain. In 2009, we expect minimal increases in our inventory due to the expected weaknesses in our sales and the limited number of retail stores we plan to open. We attempt to manage our inventory levels to avoid tying up excessive capital while maintaining sufficient inventory in order to service our current customer demand as well as plan for our expected store growth and expansion. We believe our investment in inventory at the end of 2008 was at a very reasonable level given our expansion plans as it was in line with our internal targets of optimum inventory levels.

Consolidated inventory turned 3.18 times during 2008, virtually the same as in 2007 at 3.19 times. We compute our inventory turnover rates as sales divided by average inventory.

By operating division, inventory turns are as follows:

| Segment | 2008 | 2007 | 2006 |
|------------------------------------|-------|-------|------|
| Wholesale Leathercraft | 2.14 | 2.37 | 2.40 |
| Retail Leathercraft | 6.05 | 5.87 | 6.99 |
| International Leathercraft | 4.61 | n/a | n/a |
| Roberts, Cushman | 17.75 | 25.88 | 7.15 |
| Wholesale Leathercraft stores only | 7.14 | 6.87 | 7.48 |

Retail Leathercraft inventory turns are significantly higher than that of Wholesale Leathercraft because its inventory consists only of the inventory at the stores. The retail stores have no warehouse (backstock) inventory to include in the turnover computation as the stores get their product from the central warehouse. Wholesale Leathercraft's turns are expected to be slower because the central warehouse inventory is part of this division and its inventory is held as the

backstock for all of the stores.

Accounts payable decreased slightly to \$1.1 million at the end of 2008 compared to \$1.5 million at the end of 2007.

As discussed above, the largest use of operating cash in 2008 was in the reduction of accounts payable. Cash paid for capital expenditures totaled \$2.8 million and \$1.7 million for the years ended December 31, 2008 and 2007, respectively. Total capital expenditures (both cash and non-cash) totaled \$3.6 million and \$5.8 million for the years ended December 31, 2008 and 2007, respectively. In 2007, the primary capital expenditure was the purchase of the land and building to house our corporate offices and central support departments for \$4.5 million. Other capital expenditures were factory machines and dies (\$110,000); fixtures and equipment for the new Tandy Leather retail stores (\$105,000), various store fixtures and computer equipment at existing stores (\$85,000), computer system upgrade for advertising department (\$100,000), computer equipment for future stores (\$125,000); and miscellaneous computer and other office equipment (\$250,000). In 2008, the primary capital expenditure was the remodel and retrofit of the building for \$3.2 million. Other capital expenditures were factory machines and dies (\$55,000) and computer equipment (\$415,000). Although we intend to continue opening or acquiring new Tandy Leather retail stores and therefore expenditures related to this expansion should continue into 2009, we do expect our 2009 capital expenditures to be substantially less than that of 2008 as the expenditures related to our building have been completed.

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Cash applied toward stock repurchases in 2008 totaled \$802,898.

We believe that cash flow from operations will be adequate to fund our operations in 2009, while also funding our limited expansion plans. At this time, we know of no trends or demands, commitments events or uncertainties that will or are likely to materially affect our liquidity, capital resources or results of operations. In addition, we anticipate that this cash flow will enable us to meet the contractual obligations and commercial commitments. We could defer expansion plans if required by unanticipated drops in cash flow. In particular, because of the relatively small investment required by each new retail store, we have flexibility in when we make most expansion expenditures.

Off-Balance Sheet Arrangements

We did not have any off-balance sheet arrangements during 2008, 2007 and 2006, and we do not currently have any such arrangements.

Contractual Obligations

The following table summarizes by years our contractual obligations and commercial commitments as of December 31, 2008 (not including related interest expense):

| Contractual Obligations | Total | Payments Due by Periods | | | |
|--------------------------------------|---------------------|-------------------------|--------------------|--------------------|--------------------|
| | | Less than 1 Year | 2 - 3 Years | 4 -5 Years | More than 5 Years |
| Long-Term Debt(1) | \$3,915,000 | \$202,500 | \$405,000 | \$405,000 | \$2,902,500 |
| Capital Lease Obligations | 593,949 | 265,111 | 328,838 | -- | -- |
| Operating Leases(2) | 7,480,217 | 2,468,217 | 3,602,368 | 1,303,148 | 106,484 |
| Total Contractual Obligations | \$11,989,166 | \$2,935,828 | \$4,336,206 | \$1,708,148 | \$3,008,984 |

(1) Our loan from JPMorgan Chase matures in May 2018.

(2) These are our leased facilities.

Summary of Critical Accounting Policies

We strive to report our financial results in a clear and understandable manner, although in some cases accounting and disclosure rules are complex and require us to use technical terminology. We follow generally accepted accounting principles in the U.S. in preparing our consolidated financial statements. These principles require us to make estimates and apply judgments that affect our financial position and results of operations. We continually review our accounting policies, how they are applied and how they are reported and disclosed in our financial statements. Following is a summary of our more significant accounting policies and how they are applied in preparation of the financial statements.

Basis of Consolidation. We report our financial information on a consolidated basis. Therefore, unless there is an indication to the contrary, financial information is provided for the parent company, Tandy Leather Factory, Inc., and its subsidiaries as a whole. Transactions between the parent company and any subsidiaries are eliminated for this purpose. We own all of the capital stock of our subsidiaries, and we do not have any subsidiaries that are not consolidated. None of our subsidiaries are "off balance sheet."

Revenue Recognition. We recognize revenue for retail (over the counter) sales as transactions occur and other sales upon shipment of our products, provided that there are no significant post-delivery obligations to the customer and collection is reasonably assured, which generally occurs upon shipment. Net sales represent gross sales less negotiated price allowances, product returns, and allowances for defective merchandise.

Allowance for Accounts Receivable. We reduce accounts receivable by an allowance for amounts that may become uncollectible in the future. This allowance is an estimate based primarily on our evaluation of the customer's financial condition, past collection history, and the aging of the account. If the financial condition of any of our customers deteriorates, resulting in an impairment or inability to make payments, additional allowances may be required.

Inventory. Inventory is stated at the lower of cost or market and is accounted for on the "first in, first out" method. This means that sales of inventory treat the oldest item of identical inventory as being the first sold. In addition, we regularly reduce the value of our inventory for slow-moving or obsolete inventory. This reduction is based on our review of items on hand compared to their estimated future demand. If actual future demand is less favorable than what we project, additional write-downs may be necessary. Goods shipped to us are recorded as inventory owned by us when the risk of loss shifts to us from the supplier.

Goodwill. We periodically analyze the remaining goodwill on our balance sheet to determine the appropriateness of its carry value. As of December 31, 2008, we determined that the present value of the discounted estimated future cash flows of the stores associated with the goodwill is sufficient to support their respective goodwill balances. If actual results of these stores differ significantly from our projections, such difference could affect the present value calculation in the future resulting in an impairment of all or part of the goodwill currently carried on our balance sheet.

Forward-Looking Statements

Certain statements contained in this annual report and other materials we file with the SEC, or in other written or oral statements made or to be made by us, other than statements of historical fact, are "forward-looking statements" as defined in the Private Securities Litigation Reform Act of 1995. Forward-looking statements give our current expectations or forecasts of future events. Words such as "may," "assume," "forecast," "position," "predict," "strategy," "expect," "intend," "plan," "estimate," "anticipate," "believe," "project," "budget," "potential," or "continue," and similar expressions are used to identify forward-looking statements. They can be affected by assumptions used or by known or unknown risks or uncertainties. Consequently, no forward-looking statements can be guaranteed. Actual results may vary materially. You are cautioned not to place undue reliance on any forward-looking statements. You should also understand that it is not possible to predict or identify all such factors and should not consider the following list to be a complete statement of all potential risks and uncertainties. Factors that could cause our actual results to differ materially from the results contemplated by such forward-looking statements including the risk factors described in Item 1A, "Risk Factors," of this Annual Report on Form 10-K. Management cautions that forward-looking statements are not guarantees, and our actual results could differ materially from those expressed or implied in the forward-looking statements. We do not intend to update forward-looking statements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We face exposure to financial market risks, including adverse movement in foreign current exchange rates and changes in interest rates. These exposures may change over time and could have a material impact on our financial results. We do not use or invest in market risk sensitive instruments to hedge any of these risks or for any other purpose.

Foreign Currency Exchange Rate Risk

Our primary foreign currency exposure is related to our subsidiaries in Canada and the United Kingdom as those subsidiaries have local currency revenue and local currency operating expenses. Changes in the currency exchange rates impact the U.S. dollar amount of revenue and expenses. See Note 14 to the Consolidated Financial Statements, Segment Information, for financial information concerning our foreign activities.

Interest Rate Risk

We are subject to market risk associated with interest rate movements on certain outstanding debt. However, our current credit agreement with JPMorgan Chase includes a fixed interest rate. Therefore, changes in the prime rate do not impact us in this area.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Tandy Leather Factory, Inc.
 Consolidated Balance Sheets
 December 31, 2008 and 2007

| | December 31, 2008 | December 31, 2007 |
|--|-------------------------|-------------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash | \$7,810,298 | \$6,310,396 |
| Short-term investments, including certificates of deposit | 3,011,000 | 500,000 |
| Accounts receivable-trade, net of allowance for doubtful accounts of \$43,000 and \$104,000 in 2008 and 2007, respectively | 1,180,349 | 2,538,816 |
| Inventory | 16,011,147 | 17,473,352 |
| Deferred income taxes | 229,501 | 256,938 |
| Other current assets | 777,550 | 1,102,836 |
| Total current assets | 29,019,845 | 28,182,338 |
| PROPERTY AND EQUIPMENT, at cost | 15,340,732 | 11,793,317 |
| Less accumulated depreciation and amortization | (5,019,885) | (4,794,505) |
| | 10,320,847 | 6,998,812 |
| GOODWILL | 966,655 | 990,536 |
| OTHER INTANGIBLES, net of accumulated amortization of \$367,000 and \$313,000 in 2008 and 2007, respectively | 355,492 | 384,134 |
| OTHER assets | 313,074 | 1,095,686 |
| | \$40,975,913 | \$37,651,506 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable-trade | \$1,148,577 | \$1,497,564 |
| Accrued expenses and other liabilities | 3,182,194 | 2,072,640 |
| Income taxes payable | 271,122 | 67,150 |
| Current maturities of capital lease obligation | 265,111 | - |
| Current maturities of long-term debt | 202,500 | 135,000 |
| Total current liabilities | 5,069,504 | 3,772,354 |
| DEFERRED INCOME TAXES | 600,309 | 148,648 |
| CAPITAL LEASE OBLIGATION, net of current maturities | 328,838 | - |
| LONG-TERM DEBT, net of current maturities | 3,712,500 | 3,915,000 |
| COMMITMENTS AND CONTINGENCIES | - | - |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock, \$0.10 par value; 20,000,000 shares | | |

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| | | |
|---|--------------|--------------|
| authorized, none issued or outstanding | - | - |
| Common stock, \$0.0024 par value; 25,000,000 shares | | |
| authorized, 10,994,951 and 10,982,951 shares issued at 2008 and 2007, | | |
| 10,664,555 and 10,977,092 outstanding at 2008 and 2007, respectively | 26,388 | 26,359 |
| Paid-in capital | 5,464,443 | 5,419,477 |
| Retained earnings | 26,641,853 | 24,037,672 |
| Treasury stock at cost (330,396 shares at 2008; 5,859 shares at 2007) | (828,385) | (25,487) |
| Accumulated other comprehensive income | (39,537) | 357,483 |
| Total stockholders' equity | 31,264,762 | 29,815,504 |
| | \$40,975,913 | \$37,651,506 |

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

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Tandy Leather Factory, Inc.
 Consolidated Statements of Income
 For the Years Ended December 31, 2008, 2007 and 2006

| | 2008 | 2007 | 2006 |
|--|--------------|--------------|--------------|
| NET SALES | \$53,237,094 | \$55,317,002 | \$55,199,021 |
| COST OF SALES | 21,857,800 | 23,644,599 | 23,566,251 |
| Gross Profit | 31,379,294 | 31,672,403 | 31,632,770 |
| OPERATING EXPENSES | 27,200,150 | 27,161,402 | 24,565,056 |
| INCOME FROM OPERATIONS | 4,179,144 | 4,511,001 | 7,067,714 |
| OTHER (INCOME) EXPENSE: | | | |
| Interest expense | 332,107 | 122,209 | - |
| Other, net | (265,035) | (439,040) | (98,391) |
| Total other expense | 67,072 | (316,831) | (98,391) |
| INCOME BEFORE INCOME TAXES | 4,112,072 | 4,827,832 | 7,166,105 |
| PROVISION FOR INCOME TAXES | 1,507,891 | 1,739,701 | 2,389,039 |
| NET INCOME | \$2,604,181 | \$3,088,131 | \$4,777,066 |
| NET INCOME PER COMMON SHARE – BASIC | \$0.24 | \$0.28 | \$0.44 |
| NET INCOME PER COMMON SHARE – DILUTED | \$0.24 | \$0.28 | \$0.43 |
| Weighted Average Number of Shares Outstanding: | | | |
| Basic | 10,931,306 | 10,951,481 | 10,807,316 |
| Diluted | 11,015,657 | 11,157,775 | 11,113,855 |

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

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Tandy Leather Factory, Inc.
 Consolidated Statements of Cash Flows
 For the Years Ended December 31, 2008, 2007 and 2006

| | 2008 | 2007 | 2006 |
|--|------------------|------------------|------------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income | \$2,604,181 | \$3,088,131 | \$4,777,066 |
| Adjustments to reconcile net income to net cash provided by operating activities - | | | |
| Depreciation and amortization | 985,549 | 634,291 | 392,915 |
| Loss (Gain) on disposal of assets | 13,385 | 50,114 | (3,750) |
| Non-cash stock-based compensation | 30,495 | 19,340 | 101,080 |
| Deferred income taxes | 479,098 | (63,893) | 23,222 |
| Other | (373,139) | 241,182 | (15,696) |
| Net changes in assets and liabilities, net of effect of business acquisitions: | | | |
| Accounts receivable-trade, net | 1,358,467 | 119,293 | (420,431) |
| Inventory | 1,462,205 | 156,052 | (1,500,176) |
| Income taxes | 203,972 | 7,758 | (140,189) |
| Other current assets | 325,286 | (27,946) | (731,200) |
| Accounts payable-trade | (348,987) | (327,726) | 556,226 |
| Accrued expenses and other liabilities | 1,109,554 | (1,351,369) | 873,437 |
| Total adjustments | 5,245,885 | (542,904) | (864,562) |
| Net cash provided by operating activities | 7,850,066 | 2,545,227 | 3,912,504 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Purchase of property and equipment | (2,845,548) | (1,705,367) | (471,753) |
| Payments in connection with businesses acquired | - | (771,417) | - |
| Purchases of certificates of deposit | (3,109,000) | - | - |
| Proceeds from maturities of certificates of deposit | 98,000 | - | - |
| Purchases of marketable securities | - | (500,000) | - |
| Proceeds from sale of marketable securities | 500,000 | - | - |
| Proceeds from sale of assets | 42,114 | 32,281 | 3,750 |
| Purchase of intangible assets | (24,708) | - | - |
| Decrease (increase) in other assets | 122,140 | (26,276) | 10,320 |
| Net cash used in investing activities | (5,217,002) | (2,970,779) | (457,683) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Payments on notes payable and long-term debt | (135,000) | - | - |
| Payments on capital lease obligations | (209,764) | (111,723) | (134,067) |
| Repurchase of common stock (treasury stock) | (802,898) | - | - |
| Proceeds from issuance of common stock and warrants | 14,500 | 107,780 | 203,410 |
| Net cash provided by (used in) financing activities | (1,133,162) | (3,943) | 69,343 |
| NET INCREASE IN CASH | 1,499,902 | (429,495) | 3,524,164 |

| | | | |
|---------------------------|-------------|-------------|-------------|
| CASH, beginning of period | 6,310,396 | 6,739,891 | 3,215,727 |
| CASH, end of period | \$7,810,298 | \$6,310,396 | \$6,739,891 |

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

| | | | |
|---|-----------|-----------|-----------|
| Interest paid during the period | \$332,107 | \$122,209 | \$ - |
| Income tax paid during the period, net of (refunds) | 878,110 | 1,830,688 | 2,282,113 |

NON-CASH INVESTING ACTIVITIES:

| | | | |
|---|-----------|-------------|---|
| Equipment acquired under capital lease financing arrangements | \$803,713 | - | - |
| Land and building acquired with long-term debt | - | \$4,050,000 | - |

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

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Tandy Leather Factory, Inc.
Consolidated Statements of Stockholders' Equity
For the Years Ended December 31, 2008, 2007 and 2006

| | Number of Shares | Par Value | Paid-in Capital | Treasury Stock | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total | Comprehensive Income (Loss) |
|---|---------------------|--------------|--------------------|-------------------|----------------------|--|--------------|--------------------------------|
| BALANCE, December 31, 2005 | 10,735,976 | \$25,780 | \$4,988,445 | \$(25,487) | \$16,172,475 | \$96,645 | \$21,257,857 | |
| Shares issued - stock options and warrants exercised | 143,233 | 344 | 203,066 | - | - | - | 203,410 | |
| Stock-based compensation | - | - | 101,080 | - | - | - | 101,080 | |
| Net income | - | - | - | - | 4,777,066 | - | 4,777,066 | \$4,777,066 |
| Translation adjustment | - | - | - | - | - | (16,170) | (16,170) | (16,170) |
| BALANCE, December 31, 2006 | 10,879,209 | \$26,124 | \$5,292,591 | \$(25,487) | \$20,949,541 | \$80,475 | \$26,323,243 | |
| Comprehensive income for the year ended December 31, 2006 | | | | | | | | \$4,760,896 |
| Shares issued - stock options and warrants exercised | 97,883 | 235 | 107,545 | - | - | - | 107,780 | |
| Stock-based compensation | - | - | 19,341 | - | - | - | 19,341 | |
| Net income | - | - | - | - | 3,088,131 | - | 3,088,131 | \$3,088,131 |
| Translation adjustment | - | - | - | - | - | 277,009 | 277,009 | 277,009 |
| BALANCE, December 31, 2007 | 10,977,092 | \$26,359 | \$5,419,477 | \$(25,487) | \$24,037,672 | \$357,484 | \$29,815,504 | |
| Comprehensive income for the year ended December 31, 2007 | | | | | | | | \$3,365,140 |
| Shares issued - stock options exercised | 12,000 | 29 | 14,471 | - | - | - | 14,500 | |
| Stock-based compensation | - | - | 30,495 | - | - | - | 30,495 | |
| Purchase of treasury stock | (324,537) | - | - | (802,898) | - | - | (802,898) | |
| Net income | - | - | - | - | 2,604,181 | - | 2,604,181 | \$2,604,181 |

| | | | | | | | | |
|--|-------------------|-----------------|--------------------|--------------------|---------------------|-------------------|---------------------|--------------------|
| Translation adjustment | - | - | - | - | - | (397,021) | (397,021) | (397,021) |
| BALANCE, December 31, 2008 | 10,664,555 | \$26,388 | \$5,464,443 | \$(828,385) | \$26,641,853 | \$(39,537) | \$31,264,762 | |
| Comprehensive income for the year ended December 31, 2008 | | | | | | | | \$2,207,160 |

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

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TANDY LEATHER FACTORY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2008, 2007, and 2006

1. DESCRIPTION OF BUSINESS

Our primary line of business is the sale of leather, leather crafts and related supplies. We sell our products via company-owned stores throughout the United States, Canada, and the United Kingdom. Numerous customers including retailers, wholesalers, assemblers, distributors and other manufacturers are geographically disbursed throughout the world. We also have light manufacturing facilities in Texas.

2. SIGNIFICANT ACCOUNTING POLICIES

- Management estimates and reporting

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the periods presented. Actual results could differ from those estimates. Assets and liabilities with reported amounts based on significant estimates include trade accounts receivables, inventory (slow-moving), and deferred income taxes.

- Principles of consolidation

Our consolidated financial statements include the accounts of Tandy Leather Factory, Inc. and its wholly owned subsidiaries, The Leather Factory, L.P. (a Texas limited partnership) and its corporate partners, Tandy Leather Company, L.P. (a Texas limited partnership) and its corporate partners, Mid-Continent Leather Sales, Inc. (an Oklahoma corporation), Roberts, Cushman & Company, Inc. (a Texas corporation), The Leather Factory of Canada, Ltd. (a Canadian corporation), and Tandy Leather Factory UK Limited (a UK corporation). All intercompany accounts and transactions have been eliminated in consolidation.

- Foreign currency translation

Foreign currency translation adjustments arise from activities of our Canadian and United Kingdom operations. Results of operations are translated into U.S. dollars using the average exchange rates during the period, while assets and liabilities are translated using period-end exchange rates. Foreign currency translation adjustments of assets and liabilities are recorded in stockholders' equity. Gains and losses resulting from foreign currency translations are reported in the statements of income under the caption "Other (Income) Expense", net, for all periods presented. We recognized a foreign currency translation loss of \$114,000 in 2008 and transaction gains of \$9,000 and \$52,000 in 2007 and 2006, respectively.

- Revenue recognition

Our sales generally occur via two methods: (1) at the store counter, 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. Shipping terms are normally FOB shipping point. Sales tax is excluded from revenue.

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

- Discounts

We maintain four price levels on a consistent basis: retail, wholesale, business, and distributor. Gross sales are reported after deduction of discounts. We do not pay slotting fees or make other payments to resellers. Several customers require us to participate in their cooperative advertising programs. These programs are a negotiated percentage of their purchases and are accounted for as a reduction of sales.

- Expense categories

Cost of goods sold includes inbound freight and duty charges from vendors to our central warehouse, freight and handling charges to move merchandise from our central warehouse to our stores, and manufacturing overhead, as appropriate.

Operating expenses include all selling, general and administrative costs including wages and related employee expenses (payroll taxes, health benefits, savings plans, etc.), advertising, outbound freight charges (to ship merchandise to customers), rent, and utilities.

- Property and equipment, net of accumulated depreciation and amortization

Property and equipment are stated at cost. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, which are five to ten years for equipment, five to seven years for furniture and fixtures, five years for vehicles, and forty years for buildings and related improvements. Leasehold improvements are amortized over the lesser of the life of the lease or the useful life of the asset. Repairs and maintenance costs are expensed as incurred.

- Inventory

Inventory is valued at the lower of first-in, first-out cost or market. 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.

- Impairment of long-lived assets

Potential impairments of long-lived assets are reviewed annually or when events and circumstances warrant an earlier review. In accordance with SFAS No. 144, impairment is determined when estimated future undiscounted cash flows associated with an asset are less than the asset's carrying value.

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- Earnings per share

Basic earnings per share are computed based on the weighted average number of common shares outstanding during the period. Diluted earnings per share includes, to the extent inclusion of such shares would be dilutive to earnings per share, the effect of outstanding options and warrants, computed using the treasury stock method.

| | | | |
|---|-------------|-------------|--------------|
| BASIC | 2008 | 2007 | 2006 |
| Net income (loss) | \$2,604,181 | \$3,088,131 | \$4,777,066 |
| Weighted average common shares outstanding | 10,931,306 | 10,951,481 | 10,807,316 |
| Earnings per share – basic | \$0.24 | \$0.28 | \$ 0.44 |
| DILUTED | | | |
| Net income (loss) | 2,604,181 | 3,088,131 | \$ 4,777,066 |
| Weighted average common shares outstanding | 10,931,306 | 10,951,481 | 10,807,316 |
| Effect of assumed exercise of stock options and warrants | 84,351 | 206,294 | 306,539 |
| Weighted average common shares outstanding, assuming dilution | 11,015,657 | 11,157,775 | 11,113,855 |
| Earnings per share - diluted | \$0.24 | \$0.28 | \$ 0.43 |
| Outstanding options and warrants excluded as anti-dilutive | 80,500 | 11,500 | - |

For additional disclosures regarding the employee stock options and the warrants, see Note 12. The net effect of converting stock options and warrants to purchase 232,200, 275,200 and 446,500 shares of common stock at option prices less than the average market prices has been included in the computations of diluted EPS for the years ended December 31, 2008, 2007 and 2006, respectively.

- Goodwill and other intangibles

Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," prescribes a two-phase process for impairment testing of goodwill, which is performed once annually, absent indicators of impairment. The first phase screens for impairment, while the second phase (if necessary) measures the impairment. We periodically analyze goodwill remaining on the balance sheet to determine the appropriateness of its carrying value and have elected to perform the annual analysis during the fourth calendar quarter of each year. As of December 31, 2008, we determined that the present value of the discounted estimated future cash flows of the stores associated with the goodwill is sufficient to support their respective goodwill balances. Under SFAS 142, goodwill impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value. Our reporting units are generally the same as the operating segments identified in Note 14 – Segment Information.

A summary of changes in our goodwill for the years ended December 31, 2008 and 2007 is as follows:

| | | | |
|----------------------------|--------------------|------------------|-----------|
| | Leather Factory | Tandy Leather | Total |
| Balance, December 31, 2006 | \$362,733 | \$383,406 | \$746,139 |

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| | | | |
|------------------------------|-----------|-----------|-----------|
| Acquisitions and adjustments | 225,000 | - | 225,000 |
| Foreign exchange gain/loss | 19,397 | - | 19,397 |
| Impairments | - | - | - |
| Balance, December 31, 2007 | \$607,130 | \$383,406 | \$990,536 |
| Acquisitions and adjustments | - | - | - |
| Foreign exchange gain/loss | (23,871) | - | (23,871) |
| Impairments | - | - | - |
| Balance, December 31, 2008 | 583,259 | \$383,406 | 966,655 |

As of December 31, 2008 and 2007, our intangible assets and related accumulated amortization consisted of the following:

| | As of December 31, 2008 | | |
|------------------------|-------------------------|--------------------------|-----------|
| | Gross | Accumulated Amortization | Net |
| Trademarks, Copyrights | \$544,369 | \$319,776 | \$224,593 |
| Non-Compete Agreements | 177,708 | 46,809 | 130,899 |
| | \$722,077 | 366,585 | \$355,492 |

| | As of December 31, 2007 | | |
|------------------------|-------------------------|--------------------------|-----------|
| | Gross | Accumulated Amortization | Net |
| Trademarks, Copyrights | \$544,369 | \$283,485 | \$260,884 |
| Non-Compete Agreements | 153,000 | 29,750 | 123,250 |
| | \$697,369 | \$313,235 | \$384,134 |

Excluding goodwill, we have no intangible assets not subject to amortization under SFAS 142. Amortization of intangible assets of \$53,350 in 2008, \$51,542 in 2007, and \$38,291 in 2006 was recorded in operating expenses. The weighted average amortization period is 15 years for trademarks and copyrights, and 4.22 years from non-compete agreements. Based on the current amount of intangible assets subject to amortization, the estimated amortization expense for each of the succeeding 5 years are as follows:

| | Leather Factory | Tandy Leather | Total |
|------|-----------------|---------------|----------|
| 2009 | \$29,190 | \$30,337 | \$59,527 |
| 2010 | 29,190 | 30,337 | 59,527 |
| 2011 | 26,204 | 30,337 | 56,541 |
| 2012 | 1,250 | 30,337 | 31,587 |
| 2013 | - | 30,337 | 30,337 |

During 2007 and 2008, we acquired non-compete agreements in the amounts of \$75,000 and \$24,708, respectively.

- Fair value of financial Instruments

The principal financial instruments held consist of accounts receivable, accounts payable, notes payable and long-term debt. The carrying value of accounts receivable and accounts payable approximate their fair value due to the relatively short-term nature of the accounts. The terms of the long-term debt are considered reasonable for this type of financing; therefore, the carrying amount approximates fair value.

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- Deferred taxes

Deferred income taxes result from temporary differences in the basis of our assets and liabilities reported for book and tax purposes.

- Stock-based compensation – Change in Accounting Principle

We had two stock option plans which provided for stock option grants to officers, key employees and directors. Both plans expired in the 4th quarter of 2005. The expiration of the plans have no effect on the options previously granted. Options outstanding and exercisable were granted at a stock option price which was not less than the fair market value of our Common Stock on the date the option was granted and no option has a term in excess of ten years. Additionally, options vest and become exercisable either six months from the option grant date or in equal installments over a five year period. Prior to fiscal 2006, we accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations and provided the required pro forma disclosures of SFAS No. 123, Accounting for Stock-Based Compensation.

On January 1, 2006, we adopted SFAS No. 123(R), “Share-Based Payment,” and elected to adopt the standard using the modified prospective transition method. Under this transition method, compensation cost associated with stock options recognized in 2006 includes: (1) amortization related to the remaining unvested portion of all share based payments granted prior to, but not vested as of December 31, 2005, based on the grant date fair value estimated in accordance with the original pro forma footnote disclosure provisions of FASB Statement No. 123 and (2) amortization related to all share based payments granted subsequent to December 31, 2005, based on the grant date fair value estimated in accordance with the provisions of FASB Statement No. 123(R). Accordingly, stock compensation award expense is recognized over the requisite service period using the straight-line attribution method. Previously reported amounts have not been restated.

We recognized share based compensation expense of approximately \$30,000, \$19,000, and \$101,000 for the years ended December 31, 2008, 2007 and 2006, respectively, as a component of operating expenses.

During the years ended December 31, 2008 and 2007, the stock option activity under our stock option plans was as follows:

| | Weighted # of Average shares Exercise Price | | Weighted Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value |
|--------------------------------|--|----------|--|---------------------------------|
| Outstanding, January 1, 2007 | \$2.05 | 296,200 | | |
| Granted | - | - | | |
| Cancelled | - | - | | |
| Exercised | 1.81 | (59,500) | | |
| Outstanding, December 31, 2007 | \$2.11 | 236,700 | 4.23 | \$270,780 |
| Exercisable, December 31, 2007 | \$1.97 | 220,770 | 4.11 | \$237,740 |

| | Weighted # of Average shares Exercise Price | | Weighted Average Remaining Contractual Term (in years) | Aggregate Intrinsic Value |
|--|--|--|--|---------------------------------|
|--|--|--|--|---------------------------------|

| | | | | |
|--------------------------------|--------|----------|------|-----------|
| Outstanding, January 1, 2008 | \$2.11 | 236,700 | | |
| Granted | - | - | | |
| Cancelled | - | - | | |
| Exercised | 1.21 | (12,000) | | |
| Outstanding, December 31, 2008 | \$2.16 | 224,700 | 3.09 | \$262,001 |
| Exercisable, December 31, 2008 | \$215 | 220,770 | 3.07 | \$259,461 |

Other information pertaining to option activity during the twelve month periods ended December 31, 2008, 2007 and 2006 are as follows:

| | 2008 | 2007 | 2006 |
|---|----------|----------|----------|
| Weighted average grant-date fair value of stock options granted | N/A | N/A | N/A |
| Total fair value of stock options vested | \$30,500 | \$30,500 | \$89,915 |
| Total intrinsic value of stock options exercised | \$8,779 | \$62,280 | \$90,780 |

As of December 31, 2008, there was \$3,000 of total unrecognized compensation cost related to nonvested stock options, which is expected to be recognized in 2009.

Stock options to purchase our common stock are granted at prices at or above the fair market value on the date of grant. For employees, options become exercisable in five equal installments beginning a year from the date of grant. For non-employee directors, options become exercisable six months after the date of grant. All options expire 10 years from the date of grant.

Cash received from the exercise of stock options and warrants for the years ended December 31, 2008, 2007 and 2006 was \$14,500, \$107,780, and \$203,410, respectively.

The fair value of each stock option granted is estimated on the date of grant using the BSM option valuation model. The assumptions used to calculate the fair value of options granted are evaluated and revised, as necessary, to reflect market conditions and our experience. Compensation expense is recognized only for those options expect to vest, with forfeitures estimated at the date of grant based on our historical experience and future expectations.

- Comprehensive income

Comprehensive income represents all changes in stockholders' equity, exclusive of transactions with stockholders. The accumulated balance of foreign currency translation adjustments is presented in the consolidated financial statements as "accumulated other comprehensive income or loss".

- Shipping and handling costs

All shipping and handling costs incurred by us are included in operating expenses on the statements of income. These costs totaled approximately \$1,500,000, \$1,641,000 and \$1,611,000 for the years ended December 31, 2008, 2007 and 2006, respectively.

- Advertising

With the exception of catalog costs, advertising costs are expensed as incurred. Catalog costs are capitalized and expensed over the estimated useful life of the particular catalog in question, which is typically twelve to eighteen months. Such capitalized costs are included in other current assets and totaled \$137,000 and \$218,000 at December 31, 2008 and 2007, respectively. Total advertising expense was \$3,036,346 in 2008; \$3,440,762 in 2007; and \$3,087,943 in 2006.

We agree to list the names and addresses of our Authorized Sales Centers (ASCs) in certain mailing pieces produced. The inclusion of these names and addresses are at our sole discretion. The production and distribution of direct mailings is the primary method of advertising we use and normally consists of 95 to 100 unique mailing pieces annually. Generally, the ASCs are listed in six to eight of those pieces. We believe that the inclusion of these ASC locations in the flyers has no impact on our financial statements.

- Cash flows presentation

For purposes of the statement of cash flows, we consider all highly liquid investments with initial maturities of three months or less from the date of purchase to be cash equivalents.

- Reclassifications

Certain reclassifications have been made to the 2007 financial statements to conform to the 2008 presentation.

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3. SHORT-TERM INVESTMENTS

All current fixed maturity securities are classified as “available for sale” and are reported at carrying value, which approximates fair value. We have determined that our investment securities are available to support current operations and, accordingly, have classified such securities as current assets without regard to contractual maturities. Investments at December 31, 2008 consisted of certificates of deposit. Investments at December 31, 2007 consisted of auction rate securities. The contractual maturities of the certificates of deposit as of December 31, 2008 are shown below. Actual maturities may differ from the contractual maturities because debtors may have the right to call obligations with or without call penalties.

| | |
|--------------------------------------|-------------|
| Due within one year | \$2,417,000 |
| Due between one and five years | 99,000 |
| Due between five and ten years | 99,000 |
| Due between ten and fifteen years | 198,000 |
| Due between fifteen and twenty years | 198,000 |
| | \$3,011,000 |

4. VALUATION AND QUALIFYING ACCOUNTS

- Allowance for uncollectible accounts

We maintain allowances for bad debts based on factors such as the composition of accounts receivable, the age of the accounts, historical bad debt experience, and our evaluation of the financial condition and past collection history of each customer. Accounts are written off as they are deemed uncollectible based on a periodic review of accounts. Our allowance for doubtful accounts was \$43,014 and \$104,634, respectively, at December 31, 2008 and 2007. The following is a roll forward of the allowance for doubtful accounts:

| Year ended: | Balance at beginning of year | Reserve "purchased" during year | Additions (reductions) charged to costs and expenses | Foreign exchange gain/loss | Write-offs | Balance at end of year |
|-------------------|------------------------------|---------------------------------|--|----------------------------|------------|------------------------|
| December 31, 2008 | \$104,634 | - | 65,921 | (2,768) | (124,773) | \$43,014 |
| December 31, 2007 | \$149,172 | (11,918) | 98,508 | 3,192 | (134,320) | \$104,634 |
| December 31, 2006 | \$137,587 | - | 85,439 | 241 | (74,095) | \$149,172 |

- Sales returns and defective merchandise

Product returns are generally recorded directly against sales as those returns occur. Historically, the amount of returns is immaterial and as a result, no reserve is recorded in the financial statements.

- Slow-moving and obsolete inventory

The majority of inventory items maintained by us have no restrictive shelf life. We review all inventory items annually to determine what items should be eliminated from the product line. Items are selected for several reasons: (1) the item is slow-moving; (2) the supplier is unable to provide an acceptable quality or quantity; or (3) to maintain a freshness in the product line. Once an item has been selected to discontinue, we devalue the cost of the item by 25% of its original value each quarter until its value has been reduced to zero. Reductions in inventory for

slow-moving and obsolete inventory are recorded directly against inventory.

5. BALANCE SHEET COMPONENTS

| | December 31, 2008 | December 31, 2007 |
|--|----------------------|----------------------|
| INVENTORY | | |
| On hand: | | |
| Finished goods held for sale | \$14,867,830 | \$16,482,845 |
| Raw materials and work in process | 415,644 | 633,188 |
| Inventory in transit | 727,673 | 357,319 |
| TOTAL | \$16,011,147 | \$17,473,352 |
| PROPERTY AND EQUIPMENT | | |
| Building | \$5,160,522 | \$3,060,194 |
| Land | 1,451,132 | 1,451,132 |
| Leasehold improvements | 669,329 | 1,163,947 |
| Equipment and machinery | 5,725,442 | 4,431,432 |
| Furniture and fixtures | 2,288,328 | 1,238,731 |
| Vehicles | 45,979 | 69,713 |
| Construction in progress | - | 378,168 |
| | 15,340,732 | 11,793,317 |
| Less: accumulated depreciation | (5,019,885) | (4,794,505) |
| TOTAL | \$10,320,847 | \$6,998,812 |
| OTHER CURRENT ASSETS | | |
| Accounts receivable – employees | \$42,217 | \$38,972 |
| Accounts receivable – other | 126,074 | 265,400 |
| Prepaid expenses | 575,295 | 588,004 |
| Payments for merchandise not received | 33,964 | 210,460 |
| TOTAL | \$777,550 | \$1,102,836 |
| OTHER ASSETS | | |
| Security deposits - utilities, locations, etc. | \$61,074 | \$74,057 |
| Leather art collection | 252,000 | 252,000 |
| Long-term portion of note receivable | - | 109,157 |
| Computer software not implemented yet | - | 660,472 |
| TOTAL | \$313,074 | \$1,095,686 |
| ACCRUED EXPENSES AND OTHER LIABILITIES | | |
| Accrued bonuses | \$1,068,426 | \$760,113 |
| Accrued payroll | 327,816 | 220,555 |
| Deferred revenue | 488,305 | 421,908 |
| Sales and payroll taxes payable | 169,985 | 177,786 |
| Inventory in transit | 727,673 | 357,318 |
| Other | 399,989 | 134,960 |
| TOTAL | \$3,182,194 | \$2,072,640 |

Depreciation expense was \$932,199, \$577,405, and \$348,797 for the years ended December 31, 2008, 2007 and 2006, respectively.

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6. NOTES PAYABLE AND LONG-TERM DEBT

On July 31, 2007, we entered into a Credit Agreement and Line of Credit Note with JPMorgan Chase Bank, N.A., pursuant to which the bank agreed to provide us with a credit facility of up to \$5,500,000 to facilitate our purchase of real estate consisting of a 195,000 square foot building situated on 30 acres of land located at 1900 SE Loop 820 in Fort Worth, Texas. Under the terms of the Line of Credit Note, we could borrow from time to time until April 30, 2008, up to the lesser of \$5,500,000 or 90% of the cost of the property and make monthly interest payments. On April 30, 2008, the principal balance was rolled into a 10-year term note with an interest rate of 7.10% per annum.

Proceeds in the amount of \$4,050,000 were used to fund the purchase of the property from Standard Motor Products, Inc. under an Agreement of Purchase and Sale, dated June 25, 2007, which closed on July 31, 2007. No further borrowings were drawn.

At December 31, 2008 and 2007, the amount outstanding under the above agreement consisted of the following:

| | 2008 | 2007 |
|--|--------------|--------------|
| Credit Agreement with JPMorgan Chase Bank – collateralized by real estate; payable as follows: | | |
| Line of Credit Note dated July 31, 2007, 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 | \$ 3,915,000 | \$ 4,050,000 |
| | 3,915,000 | 4,050,000 |
| Less - Current maturities | (202,500) | (135,000) |
| | \$3,712,500 | \$3,915,000 |

The terms of the credit facility contain various covenants which among other things require the Company to maintain a debt service coverage ratio of not less than 1.2 to 1.0. Scheduled maturities of the Company's notes payable and long-term debt are as follows:

| | |
|---------------------|-------------|
| 2009 | \$202,500 |
| 2010 | 202,500 |
| 2011 | 202,500 |
| 2012 | 202,500 |
| 2013 | 202,500 |
| 2014 and thereafter | 2,902,500 |
| | \$3,915,000 |

7. CAPITAL LEASE OBLIGATIONS

We lease certain HVAC equipment under a capital lease agreement. The asset subject to the agreement totaling \$803,713 is included in Property and Equipment as of December 31, 2008. Accumulated depreciation on the asset at that date was \$60,278. Amortization of the capitalized cost is charged to depreciation expense.

At December 31, 2008, the amounts outstanding under capital lease obligation consisted of the following:

| | 2008 |
|--|-----------|
| Capital Lease secured by certain HVAC equipment – total monthly principal payments of \$24,328, 5.7% interest, maturing February | \$632,538 |

| | |
|--------------------------------------|-----------|
| 2011 | |
| Less amount representing interest | 38,589 |
| Total obligation under capital lease | 593,949 |
| Less - Current maturities | 265,111 |
| | \$328,838 |

8. EMPLOYEE BENEFIT AND SAVINGS PLANS

We had an Employee Stock Ownership Plan (the "Plan") for employees with at least one year of service (as defined by the Plan) and who have reached their 21st birthday. In December 2006, the Board of Directors decided to terminate the Plan effective December 31, 2006. As a result, all participants became 100% vested in their accounts. No further contributions were made to the Plan and the accounts were fully distributed to participants in 2008.

We apply Statement of Position 93-6 (SOP 93-6), "Employers' Accounting for Employee Stock Ownership Plans," of the Accounting Standards Division of the American Institute of CPAs. During 2008, 2007, and 2006, respectively, we contributed \$0; \$0; and \$225,350 in cash as current year contributions to the plan and recognized compensation expense related to these payments.

The following table summarizes the number of shares held by the Plan and the market value as of December 31, 2008, 2007, and 2006:

| | Number of Shares | | | Market Value | | |
|-----------|------------------|---------|---------|--------------|-------------|-------------|
| | 2008 | 2007 | 2006 | 2008 | 2007 | 2006 |
| Allocated | - | 844,381 | 929,069 | - | \$2,761,126 | \$7,497,587 |
| Unearned | - | - | - | - | - | - |
| Total | - | 844,381 | 929,069 | - | \$2,761,126 | \$7,497,587 |

We have a 401(k) plan to provide retirement benefits for our employees. As allowed under Section 401(k) of the Internal Revenue Code, the plan provides tax-deferred salary contributions for eligible employees and allows employees to contribute a percentage of their annual compensation to the Plan on a pretax basis. Employee contributions are limited to a maximum annual amount as set periodically by the Internal Revenue Code. In 2008 and 2006, we matched pretax employee contributions up to 50% on the first 4% of eligible earnings that are contributed by employees. In 2007, we matched pretax employee contributions up to 100% on the first 3% of eligible earnings and 50% on the next 2% of eligible earnings.

| Year Ended December 31, | Maximum Matching Contribution per Participant* | Total Matching Contribution |
|-------------------------|--|-----------------------------|
| 2008 | \$4,600 | \$120,025 |
| 2007 | \$9,000 | \$240,774 |
| 2006 | \$4,400 | \$108,565 |

** Due to the annual limit on eligible earnings imposed by the Internal Revenue

The plan allows employees who meet the age requirements and reach the plan contribution limits to make a catch-up contribution. The catch-up contributions are not eligible for matching contributions. In addition, the plan provides for discretionary matching contributions as determined by the Board of Directors. There were no discretionary matching contributions made in 2008, 2007 or 2006.

We currently offer no postretirement or postemployment benefits to our employees.

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9. INCOME TAXES

The provision for income taxes consists of the following:

| | | 2008 | 2007 | 2006 |
|--|---------|-------------|-------------|-------------|
| Current provision: | | | | |
| | Federal | \$826,157 | \$1,494,181 | \$2,167,141 |
| | State | 202,636 | 309,413 | 198,676 |
| | | 1,028,793 | 1,803,594 | 2,365,817 |
| Deferred provision (benefit): | | | | |
| | Federal | 429,854 | (57,153) | 19,447 |
| | State | 49,244 | (6,740) | 3,775 |
| | | 479,098 | (63,893) | 23,222 |
| | | \$1,507,891 | \$1,739,701 | \$2,389,039 |

Income before income taxes is earned in the following tax jurisdictions:

| | 2008 | 2007 | 2006 |
|----------------|-------------|-------------|-------------|
| United States | \$3,716,554 | \$4,407,361 | \$6,560,994 |
| United Kingdom | (176,257) | - | - |
| Canada | 571,775 | 420,471 | 605,111 |
| | \$4,112,072 | \$4,827,832 | \$7,166,105 |

The income tax effects of temporary differences that give rise to significant portions of deferred income tax assets and liabilities are as follows:

| | 2008 | 2007 |
|--|-------------|-----------|
| Deferred income tax assets: | | |
| Allowance for doubtful accounts | \$13,351 | \$29,360 |
| Capitalized inventory costs | 128,591 | 144,099 |
| Warrants and stock-based compensation | 55,739 | 42,989 |
| Accrued expenses, reserves, and other | 87,559 | 83,478 |
| Total deferred income tax assets | 285,240 | 299,926 |
| Deferred income tax liabilities: | | |
| Property and equipment depreciation | 549,465 | 78,567 |
| Goodwill and other intangible assets amortization | 106,583 | 113,069 |
| Total deferred income tax liabilities | 656,048 | 191,636 |
| Net deferred tax asset (liability) | \$(370,808) | \$108,290 |

The net deferred tax liability is classified on the balance sheets as follows:

| | 2008 | 2007 |
|-----------------------------|-----------|-----------|
| Current deferred tax assets | \$229,501 | \$256,938 |

| | | |
|------------------------------------|-----------|-----------|
| Long-term deferred tax liabilities | (600,309) | (148,648) |
| Net deferred tax asset (liability) | \$370,808 | \$108,290 |

The effective tax rate differs from the statutory rate as follows:

| | 2008 | 2007 | 2006 |
|-----------------------|------|------|------|
| Statutory rate | 34% | 34% | 34% |
| State and local taxes | 9% | 6% | 2% |
| Other | (6%) | (4%) | (3%) |
| Effective rate | 37% | 36% | 33% |

The Company files a consolidated U.S. income tax return as well as state tax returns on a consolidated, combined or stand-alone basis, depending on the jurisdiction. The Company is no longer subject to U.S. federal income tax examinations by tax authorities for years prior to the tax year ended December 2006. Depending on the jurisdiction, the Company is no longer subject to state examinations by tax authorities for years prior to the December 2005 and December 2006 tax years.

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10. COMMITMENTS AND CONTINGENCIES

Operating Leases

We lease our store locations under five-year lease agreements that expire on dates ranging from April 2009 to April 2016. Rent expense on all operating leases for the years ended December 31, 2008, 2007, and 2006, was \$2,575,642, \$2,682,574 and \$2,495,380, respectively.

Future minimum lease payments under noncancelable operating leases at December 31, 2008 were as follows:

| | |
|------------------------------|-------------|
| Year ending December 31: | |
| 2009 | \$2,468,217 |
| 2010 | 2,061,710 |
| 2011 | 1,540,658 |
| 2012 | 995,635 |
| 2013 | 307,513 |
| 2014 and thereafter | 106,484 |
| Total minimum lease payments | \$7,480,217 |

Litigation

We are involved in various litigation that arise 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.

11. SIGNIFICANT BUSINESS CONCENTRATIONS AND RISK

Major Customers

Our revenues are derived from a diverse group of customers primarily involved in the sale of leathercrafts. While no single customer accounts for more than 6% of our consolidated revenues in 2008, 2007 and 2006, sales to our five largest customers represented 6.2%, 8.3% and 9.5%, respectively, of consolidated revenues in those years. While we do not believe the loss of one of these customers would have a significant negative impact on our operations, we do believe the loss of several of these customers simultaneously or a substantial reduction in sales generated by them could temporarily affect our operating results.

Major Vendors

We purchase a significant portion of our inventory through one supplier. Due to the number of alternative sources of supply, loss of this supplier would not have an adverse impact on our operations.

Credit Risk

Due to the large number of customers comprising our customer base, concentrations of credit risk with respect to customer receivables are limited. At December 31, 2008 and 2007, 21% and 38%, respectively, of our consolidated accounts receivable were due from two nationally recognized retail chains. We do not generally require collateral for accounts receivable, but we do perform periodic credit evaluations of our customers and believe the allowance for doubtful accounts is adequate. It is our opinion that if any one or a group of customer receivable balances should be deemed uncollectable, it would not have a material adverse effect on our results of operations and financial condition.

We maintain our cash in bank deposit accounts that, at times, may exceed federally insured limits. We have not experienced any losses in such accounts. We believe we are not exposed to any significant credit risk on our cash and cash equivalents.

12. STOCKHOLDERS' EQUITY

a) Stock Option Plans

- 2007 Director Non-Qualified Stock Option Plan

The 2007 Director Non-Qualified Stock Option Plan was adopted by the Board of Directors effective March 22, 2007 subject to stockholder approval at the Company's 2007 Annual Meeting of Stockholders. Pursuant to the plan, options to acquire an aggregate of 100,000 common shares may be granted to each individual who is serving as an outside Director of the Company on the date of grant, at the rate of 3,000 shares of Common Stock on March 22 of each calendar year. No options have been awarded as of December 31, 2008 as the Form S-8, Registration Statement under the Securities Act of 1933, has not been filed with the Securities and Exchange Commission yet.

- 1995 Stock Option Plan

In connection with the 1995 Stock Option Plan for officers and key management employees, we have outstanding options to purchase our common stock. The plan provides for the granting of either qualified incentive stock options or non-qualified options at the discretion of the Stock Option Committee of the Board of Directors. Options are granted at the fair market value of the underlying common stock at the date of grant and vest over a five-year period. We reserved 1,000,000 shares of common stock for issuance under this plan. The plan expired in the 4th quarter of 2005 with 20,000 ungranted options remaining.

- 1995 Director Non-Qualified Stock Option Plan

In connection with the 1995 Director Non-qualified Stock Option Plan for non-employee directors, we have outstanding options to purchase our common stock. The plan provides for the granting of non-qualified options at the discretion of the Directors Stock Option Committee of the Board of Directors. Options are granted at the fair market value of the underlying common stock at the date of grant and vest after six months. We reserved 100,000 shares of common stock for issuance under this plan. The plan expired in the 4th quarter of 2005 with 18,000 ungranted options remaining.

- Stock Option Summary

All options expire ten years from the date of grant and are exercisable at any time after vesting. Of the combined 1,100,000 shares available for issuance under the two plans, due to the expiration of the plan in 2005, there are no un-optioned shares available for future grants.

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A summary of stock option transactions for the years ended December 31, 2008, 2007, and 2006, is as follows:

| | 2008 | | 2007 | | 2006 | |
|--|---------------|---------------------------------|---------------|---------------------------------|---------------|---------------------------------|
| | Option Shares | Weighted Average Exercise Price | Option Shares | Weighted Average Exercise Price | Option Shares | Weighted Average Exercise Price |
| Outstanding at January 1 | 236,700 | \$2.11 | 296,200 | \$2.05 | 421,000 | \$1.93 |
| Granted | - | - | - | - | - | - |
| Forfeited or expired | - | - | - | - | - | - |
| Exchanged | - | - | - | - | - | - |
| Exercised | (12,000) | 1.21 | (59,500) | 1.81 | (124,800) | 1.63 |
| Outstanding at December 31 | 224,700 | \$2.16 | 236,700 | \$2.11 | 296,200 | \$2.05 |
| Exercisable at end of year | 222,700 | \$2.15 | 220,700 | \$1.97 | 266,200 | \$1.82 |
| Weighted-average fair value of options granted during year | - | - | - | - | - | - |

The following table summarizes outstanding options into groups based upon exercise price ranges at December 31, 2008:

| Exercise Price Range | Options Outstanding | | | Options Exercisable | | |
|----------------------|---------------------|---------------------------------|-----------------------------------|---------------------|---------------------------------|-----------------------------------|
| | Option Shares | Weighted Average Exercise Price | Weighted Average Maturity (Years) | Option Shares | Weighted Average Exercise Price | Weighted Average Maturity (Years) |
| \$0.75 or Less | 2,000 | \$0.690 | 0.74 | 2,000 | \$0.690 | 0.74 |
| \$0.76 to \$1.125 | 42,000 | 0.943 | 1.70 | 42,000 | 0.943 | 1.70 |
| \$1.126 to \$1.69 | 105,700 | 1.350 | 2.39 | 105,700 | 1.350 | 2.39 |
| \$1.70 to \$2.55 | 2,000 | 1.900 | 2.74 | 2,000 | 1.900 | 2.74 |
| \$2.56 to \$3.84 | 12,000 | 3.270 | 5.31 | 10,000 | 3.248 | 5.24 |
| \$3.85-\$4.96 | 61,000 | 4.241 | 4.91 | 61,000 | 4.241 | 4.91 |
| | 224,700 | \$2.160 | 3.09 | 222,700 | \$2.150 | 3.07 |

b) Warrants

Warrants to acquire up to 100,000 shares of common stock at \$3.10 per share were issued in conjunction with a consulting agreement to an unrelated entity in February 2003. The warrants expired on February 12, 2008.

Warrants to acquire up to 50,000 shares of common stock at \$5.00 per share were issued in conjunction with a consulting agreement to an unrelated entity in February 2004. The warrants expired on February 24, 2009.

A summary of warrant transactions for the years ended December 31, 2008, 2007, and 2006, is as follows:

| | 2008 | | 2007 | | 2006 | |
|--|---------|---------------------------------|---------|---------------------------------|---------|---------------------------------|
| | Warrant | Weighted Average Exercise Price | Warrant | Weighted Average Exercise Price | Warrant | Weighted Average Exercise Price |
| | | | | | | |

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| | Shares | Price | Shares | Price | Shares | Price |
|---|--------|---------|----------|---------|----------|----------|
| Outstanding at January 1 | 27,500 | \$3.620 | 98,300 | \$3.650 | 140,000 | \$3.7786 |
| Granted | - | - | - | - | - | - |
| Forfeited or expired | - | - | - | - | - | - |
| Exchanged | - | - | - | - | - | - |
| Exercised | - | - | (70,800) | 3.658 | (41,700) | 4.089 |
| Outstanding at December 31 | 27,500 | \$3.620 | 27,500 | \$3.620 | 98,300 | \$3.650 |
| Exercisable at end of year | 27,500 | \$3.620 | 27,500 | \$3.620 | 98,300 | \$3.650 |
| Weighted-average fair value of warrants granted during year | - | - | - | - | - | - |

The following table summarizes outstanding warrants into groups based upon exercise price ranges at December 31, 2008:

| Exercise Price Range | Warrants Outstanding | | | Warrants Exercisable | | |
|---------------------------------------|----------------------|---------------------------------|-----------------------------------|----------------------|---------------------------------|-----------------------------------|
| | Warrant | Weighted Average Exercise Price | Weighted Average Maturity (Years) | Warrant | Weighted Average Exercise Price | Weighted Average Maturity (Years) |
| \$3.00 or Less | - | - | - | - | - | - |
| More than \$3.00 and Less Than \$5.00 | 20,000 | \$3.10 | 0.12 | 20,000 | \$3.10 | 0.12 |
| \$5.00 or More | 7,500 | 5.00 | 1.15 | 7,500 | 5.00 | 1.15 |
| | 27,500 | \$3.62 | 0.40 | 27,500 | \$3.62 | 0.40 |

c) Stock Repurchase Program

On September 9, 2008, our Board of Directors approved a limited stock repurchase plan whereby all non-officer participants in Tandy Leather Factory, Inc. Stock Ownership Plan (the "ESOP") would have the option of selling the shares of our common stock distributed to them upon termination of the ESOP back to us. The option remained open to the non-officer participants for a period of sixty days beginning on September 26, 2008 and ending on November 25, 2008. The purchase price of the shares was calculated at a price-per-share equal to the closing price of a share of our common stock on the American Stock Exchange on the business day each non-officer participant notified the ESOP administrator of his or her intent to sell his or her shares to us. We repurchased a total of 324,537 shares at a total purchase price of \$802,898 in the fourth quarter of 2008.

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13. BUSINESS ACQUISITIONS

On January 31, 2007, we acquired all of the issued and outstanding shares of capital stock of Mid-Continent Leather Sales, Inc., an Oklahoma corporation. The total purchase price was \$575,000 which was funded with cash generated from operations. For financial reporting purposes, the transaction was accounted for under the purchase method, effective February 1, 2007. We also entered into a non-compete agreement with the former owner totaling \$75,000 for a period of five years. This company is included in our Wholesale Leathercraft segment.

14. SEGMENT INFORMATION

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

- a. Wholesale Leathercraft, which consists of a chain of warehouse distribution units operating under the name, The Leather Factory, located in North America;
- b. Retail Leathercraft, which consists of a chain of retail stores operating under the name, Tandy Leather Company, located in North America;
- c. International Leathercraft, sells to both wholesale and retail customers. It carries the same products as North American stores. We started this operation in February 2008 and have one store located in Northampton, United Kingdom; and
- d. Other, which consists of Roberts, Cushman and Co., a producer of decorative hat trims sold directly to hat manufacturers.

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

| | Wholesale Leathercraft | Retail Leathercraft | International Leathercraft | Other | Total |
|--------------------------------------|---------------------------|------------------------|-------------------------------|-------------|--------------|
| For the year ended December 31, 2008 | | | | | |
| Net Sales | \$26,423,858 | \$25,231,145 | \$836,535 | \$745,556 | \$53,237,094 |
| Gross Profit | 14,935,331 | 15,543,293 | 571,735 | 328,935 | 31,379,294 |
| Operating earnings | 1,842,526 | 2,188,282 | 54,532 | 93,804 | 4,179,144 |
| Interest expense | 332,107 | - | - | - | 332,107 |
| Other, net | (501,697) | 5,872 | 230,790 | - | (265,035) |
| Income before income taxes | 2,012,116 | 2,182,410 | (176,258) | 93,804 | 4,112,072 |
| Depreciation and amortization | 844,305 | 126,326 | 13,443 | 1,475 | 985,549 |
| Fixed asset additions | 3,481,851 | 74,550 | 92,859 | - | 3,649,260 |
| Total assets | \$33,657,764 | \$6,404,198 | \$778,721 | \$135,230 | \$40,975,913 |
| For the year ended December 31, 2007 | | | | | |
| Net Sales | \$29,555,979 | \$24,663,751 | - | \$1,097,272 | \$55,317,002 |
| Gross Profit | 16,446,853 | 14,733,478 | - | 492,071 | 31,672,402 |
| Operating earnings | 2,826,710 | 1,544,320 | - | 139,971 | 4,511,001 |
| Interest expense | 122,209 | - | - | - | 122,209 |
| Other, net | (425,145) | (11,975) | - | (1,920) | (439,040) |

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| | | | | | |
|-------------------------------|--------------|-------------|---|-----------|------------|
| Income before income taxes | 3,129,646 | 1,556,295 | - | 141,891 | 4,827,832 |
| Depreciation and amortization | 485,506 | 143,123 | - | 5,662 | 634,291 |
| Fixed asset additions | 5,538,803 | 207,455 | - | 9,109 | 5,755,367 |
| Total assets | \$32,217,748 | \$5,272,466 | - | \$161,292 | 37,651,506 |

For the year ended December 31, 2006

| | | | | | |
|-------------------------------|--------------|--------------|---|-------------|--------------|
| Net Sales | \$31,068,188 | \$22,520,461 | - | \$1,610,372 | \$55,199,021 |
| Gross Profit | 17,463,398 | 13,690,030 | - | 479,342 | 31,632,770 |
| Operating earnings | 4,814,240 | 2,310,073 | - | (56,599) | 7,067,714 |
| Interest expense | - | - | - | - | - |
| Other, net | 118,381 | (21,220) | - | 1,230 | 98,391 |
| Income before income taxes | 4,932,621 | 2,288,853 | - | (55,369) | 7,166,105 |
| Depreciation and amortization | 245,838 | 141,070 | - | 6,007 | 392,915 |
| Fixed asset additions | 298,689 | 172,902 | - | 162 | 471,753 |
| Total assets | \$26,529,796 | \$5,112,188 | - | \$274,651 | \$31,916,635 |

Net sales for geographic areas was as follows:

| | 2008 | 2007 | 2006 |
|---------------------|--------------|--------------|--------------|
| United States | \$46,316,115 | \$48,756,696 | \$49,188,609 |
| Canada | 4,740,722 | 4,698,510 | 4,287,180 |
| All other countries | 2,180,257 | 1,861,796 | 1,723,232 |
| | \$53,237,094 | \$55,317,002 | \$55,199,021 |

Geographic sales information is based on the location of the customer. Net sales from no single foreign country, except for Canada, was material to our consolidated net sales for the years ended December 31, 2008, 2007 and 2006. We do not have any significant long-lived assets outside of the United States.

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15. RECENT ACCOUNTING PRONOUNCEMENTS

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

In February 2007, FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities — including an amendment of FASB Statement No. 115. This statement permits entities to choose to measure many financial instruments and certain other items at fair value. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, including interim periods within that fiscal year. We did not elect the fair value option for any of our existing financial instruments. The adoption of SFAS 159 did not have a material impact on our financial position, results of operations and cash flows.

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

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

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

16. QUARTERLY FINANCIAL DATA (UNAUDITED)

| 2008 | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|--|------------------|-------------------|------------------|-------------------|
| Net sales | \$13,260,160 | \$13,847,964 | \$12,251,990 | \$13,876,980 |
| Gross profit | 7,741,022 | 8,011,652 | 7,143,157 | 8,483,463 |
| Net income | 584,498 | 655,250 | 421,014 | 943,419 |
| Net income per common share: | | | | |
| Basic | 0.05 | 0.06 | 0.04 | 0.09 |
| Diluted | 0.05 | 0.06 | 0.04 | 0.09 |
| Weighted average number of common shares outstanding: | | | | |
| Basic | 10,977,092 | 10,981,378 | 10,988,092 | 10,779,703 |
| Diluted | 11,067,863 | 11,076,340 | 11,073,942 | 10,845,517 |

| 2007 | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|--|------------------|-------------------|------------------|-------------------|
| Net sales | \$14,507,805 | \$13,376,987 | \$12,806,333 | \$14,625,877 |
| Gross profit | 8,597,953 | 7,685,669 | 6,941,634 | 8,447,147 |
| Net income | 1,346,355 | 396,692 | 171,606 | 1,173,478 |
| Net income per common share: | | | | |
| Basic | 0.12 | 0.04 | 0.02 | 0.11 |
| Diluted | 0.12 | 0.04 | 0.02 | 0.11 |
| Weighted average number of common shares outstanding: | | | | |
| Basic | 10,893,359 | 10,915,061 | 10,945,661 | 10,974,222 |
| Diluted | 11,150,246 | 11,114,466 | 11,129,757 | 11,160,034 |

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REPORT OF INDEPENDENT REGISTERED
PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
Tandy Leather Factory, Inc. and Subsidiaries

We have audited the accompanying consolidated balance sheets of Tandy Leather Factory, Inc. and Subsidiaries (the Company) as of December 31, 2008 and 2007, and the related consolidated statements of income, stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2008. The Company's management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Tandy Leather Factory, Inc. and Subsidiaries as of December 31, 2008, and 2007 and the consolidated results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America.

WEAVER AND TIDWELL, L.L.P.

Fort Worth, Texas
March 31, 2009

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ITEM 9. CHANGE IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures. Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the design and operation of our “disclosure controls and procedures” (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon their evaluation of these disclosure controls and procedures, our Chief Executive Officer and Chief Financial Officer have concluded that the disclosure controls and procedures were effective as of the date of such evaluation in ensuring that information required to be disclosed in the reports that we file or submit under the Exchange Act is (1) recorded, processed, summarized and reported in a timely manner, and (2) accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure.

Management’s Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control system was designed to provide reasonable assurance to management and the board of directors regarding the effectiveness of our internal control processes over the preparation and fair presentation of our published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

We have assessed the effectiveness of our internal controls over financial reporting as of December 31, 2008. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commissions (COSO) in Internal Control – Integrated Framework. Based on our assessment, we believe that, as of December 31, 2008, our internal control over financial reporting is effective based on that criteria.

This annual report does not include an auditor’s attestation report regarding the effectiveness of our internal control over financial reporting and our independent registered public accounting firm has not attested to management’s report on our internal control over financial reporting. Management’s report was not subject to attestation by the company’s registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit us to provide only management’s report in this annual report.

Changes in internal control. There was no change in our internal control over financial reporting that occurred during the fiscal quarter ended December 31, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None

PART III

Certain information required by Part III is omitted from this annual report as we will file a proxy statement for our 2009 Annual Meeting of Stockholders, pursuant to Regulation 14A of the Securities Exchange Act of 1934, as amended, not later than 120 days after the end of our fiscal year covered by this report, and certain information included in that proxy statement is incorporated herein by reference.

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this item is contained under the heading "Executive Officers of the Registrant" in Part I of this Annual Report on Form 10-K, and the remainder is contained in our proxy statement for our 2009 Annual Meeting of Stockholders under the heading "Election of Directors," and is incorporated herein by reference. Information relating to filings on Forms 3, 4 and 5 will be contained in our 2009 proxy statement under the heading "Section 16(a) Beneficial Ownership Reporting Compliance," and is incorporated herein by reference. Information required by this item pursuant to Items 401(h), 401(i) and 401(j) of Regulation S-K relating to an audit committee financial expert, the identification of the audit committee of our board of directors and procedures of security holders to recommend nominees to our board of directors will be contained in our 2009 proxy statement under the heading "Corporate Governance" and is incorporated herein by reference.

We have adopted a written code of ethics that applies to our employees, including our principal executive officer principal financial officer, principal accounting officer, controller, or persons performing similar functions. It is available on our website (<http://www.tandyleatherfactory.com>).

ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is contained in our proxy statement for our 2009 Annual Meeting of Stockholders under the heading "Report of the Compensation Committee," which is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item is contained in our proxy statement for our 2009 Annual Meeting of Stockholders under the headings "Stock Ownership by Directors and Executive Officers" and "Principal Holders of Stock," which is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item is contained in our proxy statement for our 2009 Annual Meeting of Stockholders under the heading "Other Relationships Involving Directors, Executive Officers, or their Associates" and is incorporated herein by reference.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is contained in our proxy statement for our 2009 Annual Meeting of Stockholders under the headings "Audit Committee" and "Report of the Audit Committee" and is incorporated herein by reference.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a) The following are filed as part of this Annual Report on Form 10-K:

1. Financial Statements

The following consolidated financial statements are included in Item 8:

- Consolidated Balance Sheets at December 31, 2008 and 2007
- Consolidated Statements of Income for the years ended December 31, 2008, 2007 and 2006
- Consolidated Statements of Cash Flows for the years ended December 31, 2008, 2007 and 2006
- Consolidated Statements of Stockholders' Equity for the years ended December 31, 2008, 2007 and 2006

2. Financial Statement Schedules

All financial statement schedules are omitted because the required information is not present or not present in sufficient amounts to require submission of the schedule or because the information is reflected in the consolidated financial statements or notes thereto.

3. Exhibits

The exhibits listed in the Exhibit Index immediately preceding such exhibits are filed as part of this Annual Report on Form 10-K.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized.

TANDY LEATHER FACTORY, INC.

By:

Dated: March 31, 2009

Ronald C. Morgan
Chief Executive Officer

By:

Shannon L. Greene
Chief Financial Officer, Chief Accounting Officer and Treasurer

In accordance with the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of Tandy Leather Factory, Inc. and in the capacities and on the dates indicated.

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| Signature | Title | Date |
|---|--|----------------|
| /s/ Wray Thompson Wray Thompson | Chairman of the Board and Director | March 31, 2009 |
| /s/ Ronald C. Morgan Ronald C. Morgan | Chief Executive Officer and Director | March 31, 2009 |
| /s/ Shannon L. Greene Shannon L. Greene | Chief Financial Officer, Chief Accounting Officer, Treasurer and Director | March 31, 2009 |
| /s/ Jon W. Thompson Jon W. Thompson | President and Chief Operating Officer | March 31, 2009 |
| /s/ Mark J. Angus Mark J. Angus | Senior Vice President | March 31, 2009 |
| /s/ T. Field Lange T. Field Lange | Director | March 31, 2009 |
| /s/ Joseph R. Mannes Joseph R. Mannes | Director | March 31, 2009 |
| /s/ L. Edward Martin III L. Edward Martin III | Director | March 31, 2009 |
| /s/ Robin L. Morgan Robin L. Morgan | Vice President and Assistant Secretary | March 31, 2009 |
| /s/ Michael A. Nery Michael A. Nery | Director | March 31, 2009 |
| /s/ William M. Warren William M. Warren | Secretary | March 31, 2009 |

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TANDY LEATHER FACTORY, INC. AND SUBSIDIARIES
EXHIBIT INDEX

| Exhibit Number | Description |
|-------------------|--|
| 3.1 | Certificate of Incorporation of The Leather Factory, Inc., and Certificate of Amendment to Certificate of Incorporation of The Leather Factory, Inc. filed as Exhibit 3.1 to Form 10-Q filed by Tandy Leather Factory, Inc. with the Securities and Exchange Commission on August 12, 2005 and incorporated by reference herein. |
| 3.2 | Bylaws of The Leather Factory, Inc., filed as Exhibit 3.2 to the Registration Statement on Form SB-2 of The Leather Factory, Inc. (Commission File No. 33-81132) filed with the Securities and Exchange Commission on July 5, 1994 and incorporated by reference herein. |
| 4.1 | Financial Advisor's Warrant Agreement, dated February 24, 2004, between The Leather Factory, Inc. and Westminster Securities Corporation filed as Exhibit 4.1 to Form 10-Q filed by The Leather Factory, Inc. with the Securities and Exchange Commission on May 14, 2004 and incorporated by reference herein. |
| 10.1 | Consultation Agreement, dated January 1, 2008, between Tandy Leather Factory, Inc. and J. Wray Thompson, filed as Exhibit 10.1 to Form 8-K filed with the Securities and Exchange Commission on April 1, 2008 and incorporated by reference herein. |
| 10.2 | 2007 Director Non-qualified Stock Option Plan of Tandy Leather Factory, Inc. dated March 22, 2007, filed as an Exhibit to Tandy Leather Factory, Inc.'s Definitive Proxy Statement, filed with the Securities and Exchange Commission on April 18, 2007 and incorporated by reference herein. |
| 10.3 | Agreement of Purchase and Sale, dated June 25, 2007, by and between Standard Motor Products, Inc. and Tandy Leather Factory, L.P., filed as Exhibit 10.4 to Form 8-K filed with the Securities and Exchange Commission on August 6, 2007 and incorporated by reference herein. |
| 10.4 | Credit Agreement, dated July 31, 2007, by and between The Leather Factory, L.P. and JPMorgan Chase Bank, N.A., filed as Exhibit 10.2 to Tandy Leather Factory's Current Report on Form 8-K filed with the Securities and Exchange Commission on August 6, 2007 and incorporated by reference herein. |
| 10.5 | Line of Credit Note, dated July 31, 2007, by and between The Leather Factory, L.P. and JPMorgan Chase Bank, N.A., filed as Exhibit 10.1 to Tandy Leather Factory's Current Report on Form 8-K filed with the Securities and Exchange Commission on August 6, 2007 and incorporated by reference herein. |
| 10.6 | Deed Of Trust, Assignment of Leases and Rents, Security Agreement and Financing Statement, dated as of July 31, 2007, by and among The Leather Factory, L.P., Randall B. Durant and JPMorgan Chase Bank, N.A., filed as Exhibit 10.3 to Tandy Leather Factory's Current Report on Form 8-K filed with the Securities and Exchange Commission on August 6, 2007 and incorporated by reference herein. |
| 10.7 | Consultation Agreement, dated as of January 1, 2008, by and between Tandy Leather Factory, Inc. and J. Wray Thompson, filed as Exhibit 10.1 to Tandy Leather Factory's Current Report on Form 8-K filed with the Securities and Exchange Commission on April 7, 2008 and incorporated by reference herein. |
| 10.8 | Consultation Agreement, dated as of January 1, 2009, by and between Tandy Leather Factory, Inc. and J. Wray Thompson, filed as Exhibit 10.1 to Tandy Leather Factory's Current Report on Form 8-K filed with the |

Securities and Exchange Commission on February 17, 2009 and incorporated by reference herein.

- 14.1 Code of Business Conduct and Ethics of The Leather Factory, Inc., adopted by the Board of Directors on February 26, 2004, filed as Exhibit 14.1 to the Annual Report on Form 10-K of The Leather Factory, Inc. (Commission File No. 1-12368) filed with the Securities and Exchange Commission on March 29, 2004 and incorporated by reference herein.
- 21.1 Subsidiaries of Tandy Leather Factory, Inc. filed as Exhibit 21.1 to the Annual Report on Form 10-K of The Leather Factory, Inc. for the year ended December 31, 2002 filed with the Securities and Exchange Commission on March 28, 2003, and incorporated by reference herein.
- *23.1 Consent of Weaver & Tidwell LLP dated March 31, 2009
- *31.1 Certification by the Chief Executive Officer and President pursuant to Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934
- *31.2 Certification by the Chief Financial Officer and Treasurer pursuant to Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934
- *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.

