

RELIABILITY INC  
Form 10QSB  
November 14, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-QSB**

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**x** **QUARTERLY REPORT UNDER SECTION 13 or 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 30, 2006

**..** **TRANSITION REPORT UNDER SECTION 13 or 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 0-7092

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**RELIABILITY INCORPORATED**

(Name of small business issuer in its charter)

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**TEXAS**  
(State or other jurisdiction of  
incorporation or organization)

15720 Park Row Suite 500  
Post Office Box 218370

**75-0868913**  
(I.R.S. Employer  
Identification Number)

77218-8370

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**Houston, Texas**  
(Address of principal executive offices)

**(281) 492-0550**

(Zip Code)

(Issuer's telephone number, including area code)

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Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past twelve 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 ninety days. YES  NO

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 6,335,965 shares of Common Stock, no par value as of November 3, 2006.

Transitional Small Business Disclosure Format (check one): Yes  No

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

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RELIABILITY INCORPORATED

FORM 10-QSB

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September 30, 2006

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## PART I - FINANCIAL INFORMATION

**Item 1. Financial Statements**

## RELIABILITY INCORPORATED

## CONSOLIDATED BALANCE SHEET

(In thousands)

|  | September 30, |
|--|---------------|
|  | 2006          |
| <b>ASSETS</b>  |               |
| Current assets:  |               |
| Cash and cash equivalents  | \$ 1,590      |
| Accounts receivable  | 68            |
| Inventories  |               |
| Prepaid expenses   | 39            |
| Other current assets   | 46            |
| Total current assets   | 1,743         |
| Property, plant and equipment, at cost:  |               |
| Machinery and equipment  | 1,157         |
| Less accumulated depreciation  | (1,155)       |
|  | 2             |
| Assets held for sale   | 1,088         |
|  | \$ 2,833      |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>   |               |
| Current liabilities:   |               |
| Accounts payable   | \$ 16         |
| Accrued liabilities  | 163           |
| Accrued termination benefits   | 300           |
| Total current liabilities  | 479           |
| Stockholders' equity:  |               |
| Common stock, without par value; 20,000,000 shares authorized; 6,690,265 shares issued | 9,746         |
| Accumulated deficit  | (6,297)       |
| Less treasury stock at cost, 354,300 shares  | (1,095)       |
| Total stockholders' equity   | 2,354         |
|  | \$ 2,833      |

See accompanying notes.



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## RELIABILITY INCORPORATED

## UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

|  | Nine Months Ended |            |
|--|-------------------|------------|
|  | September 30,     |            |
|  | 2006              | 2005       |
| Revenue  | \$ 230            | \$ 491     |
| Costs and expenses:  |                   |            |
| Cost of goods sold   | 217               | 704        |
| Marketing, general and administrative  | 1,046             | 1,651      |
| Research and development   |                   | 606        |
|  | 1,263             | 2,961      |
| Operating loss from continuing operations  | (1,033)           | (2,470)    |
| Interest (expense)   | (167)             | (151)      |
| Interest income  | 34                | 12         |
| Gain on the sale of assets   | 1,689             |            |
| Other income   | 39                | 23         |
|  | 1,595             | (116)      |
| Income (loss) from continuing operations, before income taxes                            | 562               | (2,586)    |
| Provision for income taxes   |                   |            |
| Income (loss) from continuing operations   | 562               | (2,586)    |
| Loss from discontinued operations, net of income tax provisions of nil for 2006 and 2005 | (591)             | (406)      |
| Net loss   | \$ (29)           | \$ (2,992) |
| Basic and diluted earning (loss) per share:  |                   |            |
| Continuing operations  | \$ .09            | \$ (.41)   |
| Discontinued operations  | (.09)             | (.06)      |
| Net income (loss)  | \$                | \$ (.47)   |
| Weighted average shares:   |                   |            |
| Basic  | 6,336             | 6,336      |
| Diluted  | 6,336             | 6,336      |

See accompanying notes.

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## RELIABILITY INCORPORATED

## UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except share data)

|   | Three Months Ended    |          |
|---|-----------------------|----------|
|   | September 30,<br>2006 | 2005     |
| Revenue   | \$ 8                  | \$ 187   |
| Costs and expenses:   |                       |          |
| Cost of goods sold  | 2                     | 159      |
| Marketing, general and administrative   | 299                   | 604      |
| Research and development  |                       | 80       |
|   | 301                   | 843      |
| Operating loss from continuing operations   | (293)                 | (656)    |
| Interest (expense)  |                       | (65)     |
| Interest income   | 21                    | 4        |
| Other income  | 3                     | 14       |
|   | 24                    | (47)     |
| Loss from continuing operations, before income taxes                                    | (269)                 | (703)    |
| Provision for income taxes  |                       |          |
| Loss from continuing operations   | (269)                 | (703)    |
| Loss from discontinued operations, net of income tax provisions of nil in 2006 and 2005 | (127)                 | (14)     |
| Net loss  | \$ (396)              | \$ (717) |
| Basic and diluted loss per share:   |                       |          |
| Continuing operations   | \$ (.04)              | \$ (.11) |
| Discontinued operations   | (.02)                 |          |
| Net loss  | \$ (.06)              | \$ (.11) |
| Weighted average shares:  |                       |          |
| Basic   | 6,336                 | 6,336    |
| Diluted   | 6,336                 | 6,336    |

See accompanying notes.

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## RELIABILITY INCORPORATED

## UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

|  | Nine Months Ended     |         |
|--|-----------------------|---------|
|  | September 30,<br>2006 | 2005    |
| Cash flows from operating activities:  |                       |         |
| Net (loss)   | (29)                  | (2,992) |
| Loss from discontinued operations  | 591                   | 406     |
| Income (loss) from continuing operations   | 562                   | (2,586) |
| Adjustments to reconcile net income (loss) to cash used by operating activities: |                       |         |
| Depreciation and amortization  | 4                     | 214     |
| Impairment charges   |                       | 81      |
| Provision for inventory obsolescence   | (11)                  | 134     |
| Stock option expense   | 25                    |         |
| (Gain) on sale of assets   | (1,630)               | (40)    |
| (Gain)/loss on equity investments  | (59)                  | 37      |
| Changes in operating assets and liabilities:                                     |                       |         |
| Accounts receivable  | 215                   | 125     |
| Inventories  | 41                    | 99      |
| Prepaid expenses   | 106                   | 82      |
| Accounts payable   | (29)                  | 19      |
| Accrued liabilities  | (201)                 | 61      |
| Total adjustments  | (1,539)               | 812     |
| Net cash used in continuing operations   | (977)                 | (1,774) |
| Net cash used in discontinued operations   | (235)                 | (155)   |
| Net cash used by operating activities  | (1,212)               | (1,929) |
| Cash flows from investing activities:  |                       |         |
| Expenditures for property and equipment  |                       | (2)     |
| Proceeds from sale of investment securities                                      | 208                   |         |
| Proceeds from sale of assets   | 4,108                 | 65      |
| Proceeds from sale of discontinued operation                                     | 300                   |         |
| Net cash provided by investing activities  | 4,616                 | 63      |
| Cash flows from financing activities:  |                       |         |
| Borrowings under line of credit  | 330                   | 1025    |
| Repayments on line of credit   | (1,855)               | (150)   |
| Repayments on notes payable  | (1,031)               | (9)     |
| Net cash (used) provided by financing activities                                 | (2,556)               | 866     |
| Net increase (decrease) in cash  | 848                   | (1,000) |
| Cash and cash equivalents:   |                       |         |
| Beginning of period  | 742                   | 1,617   |
| End of period  | 1,590                 | 617     |



Supplemental cash flow information:

Interest paid

See accompanying notes.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

**1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Basis of presentation***

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with instructions to Form 10-QSB and Item 10 of Regulation S-B. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the interim period ended September 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

The consolidated financial statements include the financial transactions and accounts of the Company and its wholly-owned subsidiary. All significant intercompany balances and transactions have been eliminated in consolidation. For further information, refer to the financial statements and footnotes thereto included in the Company's annual report on Form 10-KSB for the year ended December 31, 2005.

Certain expenses on the consolidated statement of operations for the three and nine months ended September 30, 2005 have been reclassified to be consistent with the classifications adapted for the three and nine months ended September 30, 2006. These reclassifications had no effect on net income.

***Accounting Estimates***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires that management 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 the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

***Income Taxes***

Deferred income taxes are provided under the liability method and reflect the net tax effects of temporary differences between the tax basis of assets and liabilities and their reported amounts in the consolidated financial statements. The Company establishes valuation allowances when the realization of specific deferred tax assets are subject to significant uncertainty. The Company recorded no tax benefits on its operating losses, as the losses will have to be carried forward and realization of any benefit is uncertain.

***Inventories***

Inventories are stated at the lower of standard cost (which approximates first-in, first-out) or market (replacement cost or net realizable value). Inventories at September 30, 2006 were \$0 net of reserves for excess and obsolete inventories of \$136,414.

***Earning per Share***

Basic and diluted earnings per share are computed based on 6,335,965 shares outstanding, since the effect of including the impact of the assumed exercise of outstanding stock options is anti-dilutive.

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## RELIABILITY INCORPORATED

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

**2. LIQUIDITY**

As a result of the continuing deterioration in its financial position, the Company has taken several major steps during 2006 that reduce the Company's expenses and improve the Company's liquidity. In March 2006, the Company sold its former Power Sources division (See Note 6). In April 2006, the Company announced plans to close its Services division in Singapore (See Note 6). In June 2006, the Company sold of its Houston headquarters building (See Note 7). Although these actions have produced sufficient cash for the Company to operate its remaining Test and Conditioning Products business line through the balance of 2006 and into 2007, the Company does not believe this business line will return to profitability or generate positive cash flow in the foreseeable future. Therefore, the Company has no plans to resume research and development activities. Based upon its current financial position, and an evaluation of the prospects for continuing to operate its remaining business line, the Company has concluded that it should pursue one, or some combination, of the following courses of action: sell its remaining real estate holdings; sell its remaining business line; invest in another line of business through a purchase or merger; make distributions to its shareholders of the proceeds of asset or business line sales, possibly through a corporate liquidation. There can be no assurances that the Company will be able to successfully complete any of these transactions or be able to maintain sufficient liquidity over a period of time that will allow it to carry out these actions, in which case the Company might be forced to liquidate or seek protection under the Federal bankruptcy statutes, or both.

**3. COMPREHENSIVE LOSS**

The only difference between the total comprehensive loss and the net loss reported on the Consolidated Statements of Operations arises from unrealized gains and losses on available-for-sale securities. All such securities were sold as of March 31, 2006. The Company's total comprehensive loss (in thousands) for the periods indicated, is as follows:

|  | Nine Months Ended<br>September 30, |            | Three Months Ended<br>September 30, |          |
|--|------------------------------------|------------|-------------------------------------|----------|
|  | 2006                               | 2005       | 2006                                | 2005     |
| Net (loss)   | \$ (29)                            | \$ (2,992) | \$ (396)                            | \$ (717) |
| Unrealized net gains on marketable equity securities                       |                                    | 5          |                                     | 22       |
| Less reclassification adjustment for (losses)/gains included in net income | (59)                               | 37         |                                     |          |
| Total comprehensive (loss)   | \$ (88)                            | \$ (2,950) | \$ (396)                            | \$ (695) |

**4. OTHER INCOME**

Other income consists of the following:

|  | Nine Months Ended<br>September 30, |       | Three Months Ended<br>September 30, |       |
|--|------------------------------------|-------|-------------------------------------|-------|
|  | 2006                               | 2005  | 2006                                | 2005  |
| Rental income                            | \$ 26                              | \$ 59 | \$                                  | \$ 13 |
| Write-down of investment securities      |                                    | (37)  |                                     |       |
| Proceeds from class action settlements   | 3                                  |       | 3                                   |       |
| Gain on disposal of miscellaneous assets | 10                                 | 1     |                                     | 1     |
|  | \$ 39                              | \$ 23 | \$ 3                                | \$ 14 |



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## RELIABILITY INCORPORATED

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

**5. STOCK OPTION PLAN**

January 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards 123(R), *Share-Based Payment* ( SFAS 123(R) ). SFAS 123(R) requires that the compensation cost relating to stock-based payments, including grants of employee stock options, be recognized in financial statements. That cost is measured based on the fair value of the equity instruments issued. SFAS 123(R) allows two methods for determining the effects of the transition: the modified-prospective transition method and the modified-retrospective method of transition. The Company adopted the modified-prospective method. Under this transition method, the Company recognizes the fair value of stock-based compensation awards as compensation expense in its statement of operations on a straight line basis, over the vesting period, for awards granted after January 1, 2006 and for unvested awards outstanding as of December 31, 2005.

Prior to January 1, 2006, the Company accounted for its stock option plan using the intrinsic value method under Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees* ( APB 25 ), and related interpretations, as permitted by Statement of Financial Accounting Standards 123, *Accounting for Stock-Based Compensation* ( SFAS 123 ), under which no compensation expense was recognized for stock option grants. Accordingly, share based compensation related to stock options was included as a pro forma disclosure in the financial statement footnotes and continues to be for periods prior to 2006.

The following table provides pro forma net loss and loss per share had the Company applied the fair value method of SFAS 123 for the nine months and three months ended September 30, 2005 (in thousands, except per share data):

|   | <b>Nine Months Ended<br/>September 30 2005</b> | <b>Three Months Ended<br/>September 30 2005</b> |
|---|--|---|
| Reported net loss:  | \$ (2,992)                                     | \$ (717)  |
| Deduct: Total stock-based employee compensation expense for all awards                                  | (43)   | (3)   |
| <b>Pro forma net loss</b>   | <b>\$ (3,035)</b>                              | <b>\$ (720)</b>                                 |
| Basic and Diluted loss per share as reported:   |  |   |
| Continuing operations   | \$ (.41)                                       | \$ (.11)  |
| Discontinued operations   | (.06)  |   |
| <b>Net Loss</b>   | <b>\$ (.47)</b>                                | <b>\$ (.11)</b>                                 |
| Pro forma Basic and Diluted loss per share, as if the fair value method had been applied to all awards: |  |   |
| Continuing operations   | \$ (.42)                                       | \$ (.11)  |
| Discontinued operations   | (.06)  |   |
| <b>Net Loss</b>   | <b>\$ (.48)</b>                                | <b>\$ (.11)</b>                                 |

The adoption of SFAS 123(R), on January 1, 2006, resulted in recognition of compensation expense of \$22,000, or \$.0 per share for the three months ended September 30, 2006 and \$25,000, or \$.0 per share for the nine months ended September 30, 2006. The total cost related to non-vested awards not yet recognized at September 30, 2006 is approximately \$22,000, which is expected to be recognized during the 4<sup>th</sup> quarter of 2006.

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Due to the Company's substantial tax loss carryforwards, no income tax benefit has been recognized with respect to stock-based compensation expense for the nine months ended September 30, 2006.

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## RELIABILITY INCORPORATED

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

Under the Company's Amended and Restated 1997 Stock Option Plan (Option Plan), stock option grants are available for officers, directors, and key employees. The objectives of the Option Plan are to promote the interest of the Company by providing an ownership incentive to officers, directors, and key employees, to reward outstanding performance, and to encourage continued employment. The Board of Directors, which acts as the Plan Administrator, determines to whom options are granted, the type of options, the number of shares covered by such options and the option vesting schedule. The Option Plan provides for the grant of stock options to purchase an aggregate of up to 1,500,000 shares of the Company's Common Stock. All options are issued at market value on the date of the grant and generally have a ten-year contractual term with graded vesting.

The fair value of each option is estimated on the date of grant using a Black-Scholes option-pricing model. Expected volatilities are based on a number of factors, including historical volatility of the Company's stock. The Company uses the shortcut method described in SAB Topic 14D.2 for determining the expected life used in the valuation model. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. As the Company has not declared dividends since it became a public entity, no dividend yield is used in the calculation. For the options granted during the three month ended September 30, 2006, the following criteria was used: (i) an average risk free interest rate of 5.09%, (ii) an average volatility of 58% and (iii) an average contractual life of 5.25 years.

The fair value of options vested during the first nine months of 2006 was approximately \$3,000. The weighted average grant date fair value estimate of options granted during the nine months ended September 30, 2006 was \$.12. All outstanding options were out-of-the-money as of September 30, 2006, resulting in an aggregate intrinsic value of nil. The weighted-average remaining contractual term, as of September 30, 2006, was 6.4 years for outstanding options and 4.3 years for exercisable options. The following table summarizes option activity for the three months and nine months ended September 30, 2006:

|                                      | Number of<br>Options | Weighted<br>Average<br>Price |
|--------------------------------------|----------------------|------------------------------|
| Balance as of June 30, 2006          | 642,851              | \$ 2.56                      |
| Expired                              | (16,000)             | 1.64                         |
| Exercised                            |                      |                              |
| Granted                              | 370,000              | .21                          |
| Balance as of September 30, 2006     | 996,851              | \$ 1.71                      |
| Balance as of December 31, 2005      | 834,851              | \$ 2.40                      |
| Expired                              | (208,000)            | 1.82                         |
| Exercised                            |                      |                              |
| Granted                              | 370,000              | .21                          |
| Balance as of September 30, 2006     | 996,851              | \$ 1.71                      |
| Exercisable as of September 30, 2006 | 621,851              | \$ 2.60                      |

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## RELIABILITY INCORPORATED

## NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

**6. DISCONTINUED OPERATIONS**

On January 29, 2005, the Company terminated the Asset Purchase Agreement for the purchase of the Ezy-Load product line. The Company elected to terminate the agreement due to disappointing sales of the product and the amount of capital required to sustain the sales and marketing efforts. As a result of the termination, the Company's former Automotive division was abandoned and is included in loss for discontinued operations.

On March 14, 2006, the Company sold its Power Sources Division to Reliability Power, Inc., an unaffiliated third party. Proceeds from the sale were \$300,000. A gain of \$108,000 was realized and is included in income from discontinued operations.

On April 18, 2006, the Company announced plans to close down its Services division located in Singapore. During the wind down of operations, the division has continued to provide limited services for its customers while they seek alternative service providers. The Company has accrued \$300,000 for estimated termination benefits related to the closure of its Singapore facility and is included in loss from discontinued operations.

Results of operations for the former Automotive, Power Sources, and Services divisions are reported as discontinued operations in the accompanying Statement of Operations for each period presented. Net sales and the loss from discontinued operations are as follows (in thousands):

|   | Nine Months Ended<br>September 30, |          | Three Months Ended<br>September 30, |         |
|---|------------------------------------|----------|-------------------------------------|---------|
|   | 2006                               | 2005     | 2006                                | 2005    |
| Revenues:                                   |                                    |          |                                     |         |
| Automotive                                  | \$                                 | \$ 37    | \$                                  | \$      |
| Power Sources                               | 131                                | 519      |                                     | 142     |
| Services                                    | 520                                | 1,127    |                                     | 432     |
|   | \$ 651                             | \$ 1,683 | \$                                  | \$ 574  |
| Income (loss) from discontinued operations: |                                    |          |                                     |         |
| Automotive                                  | \$                                 | \$ 7     | \$                                  | \$ 28   |
| Power Sources                               | 59                                 | (228)    |                                     | (52)    |
| Services                                    | (650)                              | (185)    | (127)                               | 10      |
|   | \$ (591)                           | \$ (406) | \$ (127)                            | \$ (14) |



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RELIABILITY INCORPORATED

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2006

**7. SALE OF HEADQUARTERS BUILDING**

In June 2006, the Company completed the sale of its Houston headquarters, previously reported as Asset Held For Sale. Net proceeds to the Company were \$3.9 million. As a result of the sale, the Company repaid all borrowing under its credit agreements of \$2.5 million.

**8. ASSETS HELD FOR SALE**

Assets held for sale consists of the following (in thousands):

|                      |                |    |          |
|----------------------|----------------|----|----------|
| Production equipment | Singapore      | \$ | 88       |
| Land and building    | North Carolina | \$ | 1,000    |
|                      |                |    | \$ 1,088 |

**9. STATEMENT OF CASH FLOWS**

In 2006, the Company has separately disclosed the operating portions of the cash flows attributable to discontinued operations.

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RELIABILITY INCORPORATED  
MANAGEMENT'S DISCUSSION AND ANALYSIS OR  
PLAN OF OPERATIONS

September 30, 2006

*Item 2. Management's Discussion and Analysis or Plan of Operations*

**FORWARD-LOOKING STATEMENTS**

This Management's Discussion and Analysis or Plan of Operations and other parts of this report contain forward-looking statements that involve risks and uncertainties, as well as current expectations and assumptions. From time to time, the Company may publish forward-looking statements, including those that are contained in this report, relating to such matters as anticipated financial performance, business prospects, technological developments, new products, research and development activities and similar matters. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. In order to comply with the terms of the safe harbor, the Company notes that a variety of factors could cause the Company's actual results and experience to differ materially from the anticipated results or other expectations expressed in the Company's forward-looking statements. The risks and uncertainties that may affect the operations, performance, development and results of the Company's business include, but are not limited to, its ability maintain sufficient working capital, adverse changes in the economy, the ability to attract and maintain key personnel, the ability to sell its remaining real estate holdings or business line, its ability to identify or complete a merger or acquisition, and future results related to acquisition, merger or investment activities. The Company's actual results could differ materially from those anticipated in these forward-looking statements, including those set forth elsewhere in this report. The Company assumes no obligation to update any such forward-looking statements.

**CRITICAL ACCOUNTING POLICIES AND COMMENTS RELATED TO OPERATIONS**

The Company has defined a critical accounting policy as one that is both important to the portrayal of the Company's financial condition and results of operations and requires the management of the Company to make difficult, subjective or complex judgments. Estimates and assumptions about future events and their effects cannot be perceived with certainty. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments. These estimates may change as new events occur, as more experience is acquired, as additional information is obtained and as the Company's operating environment changes. There have been no material changes or developments in the Company's evaluation of the accounting estimates and the underlying assumptions or methodologies that it believes to be Critical Accounting Policies and Estimates as disclosed in its Form 10-KSB for the year ended December 31, 2005.

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RELIABILITY INCORPORATED  
MANAGEMENT'S DISCUSSION AND ANALYSIS OR  
PLAN OF OPERATIONS

September 30, 2006

Management's Discussion included in the Form 10-KSB for the year ended December 31, 2005 includes discussion of various factors related to the decline in the Company's revenues and items related to the Company's results of operations, liquidity and markets. Other than completion of the sale of the Company's Power Sources division, the completion of the sale of the Company's headquarters building and the announced closing of its Services division in Singapore, there have been no other significant changes in most of the factors discussed in the Form 10-KSB and many of the items discussed in the Form 10-KSB are relevant to 2006 operations; thus the reader of this report should read Management's Discussion included in Form 10-KSB for the year ended December 31, 2005.

**LIQUIDITY AND CAPITAL RESOURCES**

As a result of the continuing deterioration in its financial position, the Company has taken several major steps during 2006 that both reduce the Company's expenses and improve the Company's liquidity. In March 2006, the Company sold its former Power Sources division, realizing \$300,000 in cash proceeds. In April 2006, the Company announced plans to close its Services division in Singapore. In June 2006, the Company sold its Houston headquarters building. Net proceeds to the Company were approximately \$3.9 million. As a result of the sale, the Company repaid all its debt, and cash increased by approximately \$1.4 million. Although these actions have produced sufficient cash for the Company to operate its remaining business line through the balance of 2006 and into 2007, the Company does not believe the business line will return to profitability or generate positive cash flow in the foreseeable future. Therefore, the Company has no plans to resume research and development activities in its Testing Products division. Based upon its current financial position, and an evaluation of the prospects for continuing to operate its remaining business segment, the Company has concluded that it should pursue one, or some combination, of the following courses of action: sell its remaining real estate holdings; sell its remaining business unit; invest in another line of business through a purchase or merger; make distributions to its shareholders of the proceeds of asset or business line sales, possibly through a corporate liquidation. There can be no assurances that the Company will be able to successfully complete any of these transactions or be able to maintain sufficient liquidity over a period of time that will allow it to carry out these actions, in which case the Company might be forced to liquidate or seek protection under the Federal bankruptcy statutes, or both.

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RELIABILITY INCORPORATED  
MANAGEMENT'S DISCUSSION AND ANALYSIS OR  
PLAN OF OPERATIONS

September 30, 2006

Net cash used by operating activities during the nine months ended September 30, 2006 was \$1,212,000 compared to \$1,929,000 used by operations in the comparable period of 2005. The principal item contributing to the difference was a net loss of \$29,000 for 2006 compared with a net loss of \$2,992,000 for the same period in 2005, partially offset by \$1,689,000 in gains on the sale of assets and securities, \$210,000 decrease in depreciation and amortization charges, \$145,000 reduction in inventory obsolescence provisions, and \$262,000 decrease in accrued liabilities as a result of the sale of the Company's headquarters building, lower business activity and reductions in staffing.

During the nine months ended September 30, 2006, investing activities provided \$4,616,000 of cash, compared to \$63,000 during the same period of 2005. The increase in cash is the result of a \$4,043,000 increase in proceeds on the sale of assets, \$300,000 from the sale of Power Sources and \$208,000 from the sale of investment securities.

Financing activities, during the nine months ended September 30, 2006, consumed \$2,556,000 in cash as a result of the Company repaying all borrowing under the its credit agreements.

**RESULTS OF OPERATIONS**

**Nine months ended September 30, 2006 compared to nine months ended September 30, 2005.**

***Revenues.***

Revenues during the first nine months of 2006 declined 53% to \$230,000 from \$491,000 for the same period of 2005. The decline was the result of lower system refurbishment/upgrade activity.

***Gross Profit***

Gross margin during the nine months ended September 30, 2006 was \$13,000 compared with (\$213,000) during the same period of 2005. The increase in gross margin is primarily the result of changes in product mix, \$152,000 reduction in payroll and payroll related expenses and \$125,000 reduction in general operating expenses as a result of lower business activity and reductions in staffing.

***Marketing, General and Administrative***

Marketing, general and administrative expenses decreased from \$1,651,000 in the nine months ended September 30, 2005 to \$1,046,000 for the same 2006 period. Expense reductions resulted from a \$555,000 decrease in payroll and related cost due to staff reductions implemented in August 2005, a \$75,000 decrease in amortization cost for demonstration equipment incurred in 2005 for which there is no corresponding expense in 2006, and \$114,000 reduction in depreciation due mainly to the reclassification of the Company's headquarters to Asset Held For Sale and no longer subject to depreciation.

***Research and Development***

Research and development costs were \$606,000 during the nine months ended September 30, 2005 compared with nil for the same period of 2006. As a part of cost cutting measures implemented in August of 2005, the Company suspended all research and development activities.

***Interest Expense***

Interest expense for the nine months ended September 30, 2006 was \$167,000 and \$151,000 for the same period of 2005 as a result of borrowing under the Company's credit agreements. The Company has repaid all debt under the Company's credit and loan agreements as of June 30, 2006.

***Other Income - Net***

Other income was \$39,000 for the nine months ended September 30, 2006 compared with \$23,000 for the same period of 2005. The net increase results from a \$37,000 write down in the value of investment securities during 2005 offset by a decline of rental income during 2006, as a result of the Company selling its Houston facility.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OR  
PLAN OF OPERATIONS

September 30, 2006

**Three months ended September 30, 2006 compared to three months ended September 30, 2005.**

***Revenues.***

Revenues for the three months ended September 30, 2006 were \$8,000 compared to \$187,000 for the same period of 2005. The decline in revenues was due to no system upgrades during the 3rd quarter of 2006. Revenues came from spare parts sales and field service support activities.

***Gross Profit***

Gross margin during the three months ended September 30, 2005 was \$28,000 compared with \$6,000 during the same period of 2006. The change in gross margin is primarily the result of lower volume, changes in product mix, a \$53,000 reduction in payroll and payroll related expenses, an \$85,000 decrease in reserve accruals for excess and obsolete inventory, and a \$37,000 reduction in general operating expenses offset by the reduction in revenues.

***Marketing, General and Administrative***

Marketing, general and administrative expenses decreased from \$604,000 in the three months ended September 30, 2005 to \$299,000 for the same 2006 period. Expense reductions were primarily the result of a \$232,000 decrease in labor cost due to staff reductions, a \$41,000 decrease in general operating expenses due to lower business activity and reductions in staffing, and a \$35,000 reduction in depreciation due mainly to the reclassification of the Company's headquarters to Asset Held For Sale and no longer subject to depreciation.

***Research and Development***

Research and development costs were \$80,000 during the three months ended September 30, 2005 compared with nil for the same period of 2006. As a part of cost cutting measures implemented in August of 2005, the Company suspended all research and development activities.

***Interest Expense***

The Company had no interest expense for the three months ended September 30, 2006 compared with \$65,000 for the same period of 2005, as a result of repaying all borrowings under the Company's credit and loan agreements in June of 2006.

***Other Income - Net***

Other income was \$3,000 for the three months ended September 30, 2006 compared with \$14,000 for the same period of 2005. The decrease results from a \$14,000 drop in rental income as a result of the Company selling its Houston facility, partially offset by \$3,000 in proceeds from class action settlements on securities held.

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MANAGEMENT'S DISCUSSION AND ANALYSIS OR  
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September 30, 2006

***Item 3. Controls and Procedures.***

Within 90 days prior to the date of this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Acting Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Rule 13a-5 under the Securities Exchange Act. Based on that evaluation, the Company's Chief Executive Officer and Acting Chief Financial Officer had concluded that the Company's disclosure controls and procedures are effective.

There have been no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of the evaluation described in the preceding paragraph.

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OTHER INFORMATION

**PART II - OTHER INFORMATION**

September 30, 2006

*Items 1 through 5 are not applicable and have been omitted.*

***Item 6. Exhibits:***

The following exhibits are filed as part of this report:

- 31.1 Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as Amended
- 31.2 Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as Amended
- 32 Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002



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SIGNATURES

September 30, 2006

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

RELIABILITY INCORPORATED  
(Registrant)

November 14, 2006

/s/ Larry Edwards  
Larry Edwards  
President and Chief Executive Officer

November 14, 2006

/s/ James M. Harwell  
James M. Harwell  
Acting Chief Financial Officer