

RELIABILITY INC
Form 10KSB
March 31, 2008
Table of Contents

Index to Financial Statements

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-KSB

Annual Report Pursuant to Section 13 or 15 (d)
of the Securities Exchange Act of 1934

For the Fiscal Year Ended December 31, 2007

Commission File Number 0-7092

RELIABILITY INCORPORATED

(Exact name of registrant as specified in its charter)

TEXAS
(State or other jurisdiction
of incorporation or organization)

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

Edgar Filing: RELIABILITY INC - Form 10KSB

Post Office Box 218670
Houston, Texas
(Address of principal executive offices)

77218-8670
(Zip Code)

(281) 492-0550

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: None

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

Common Stock, no par value per share

(Title of class)

Indicate by check mark whether the issuer is not required to file reports pursuant to Section 13 or 15(d) of the Exchange Act.

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 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

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 the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

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

State issuer's revenues for its most recent fiscal year: 0

State the aggregate market value of the voting and non-voting common equity held by non-affiliates; computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of March 18, 2008: \$506,877.

Number of shares outstanding of the issuer's Common Stock as of March 18, 2008: 6,335,965.

Documents Incorporated by Reference

None.

Transitional Small Business Disclosure Format (check one). YES NO

Table of Contents

Index to Financial Statements

RELIABILITY INCORPORATED

Form 10-KSB

TABLE OF CONTENTS

December 31, 2007

PART I

| | Page |
|--|-------------|
| Item 1. <u>Description of Business</u> | 3 |
| Item 2. <u>Description of Properties</u> | 8 |
| Item 3. <u>Legal Proceedings</u> | 8 |
| Item 4. <u>Submission of Matters to a Vote of Security Holders</u> | 8 |

PART II

| | |
|---|----|
| Item 5. <u>Market for Common Equity, Related Stockholder Matters and Small Business Issuer Purchases of Equity Securities</u> | 9 |
| Item 6. <u>Management's Discussion and Analysis or Plan of Operation</u> | 10 |
| Item 7. <u>Financial Statements</u> | 13 |
| Item 8. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u> | 13 |
| Item 8A. <u>Controls and Procedures</u> | 14 |
| Item 8B. <u>Other Information</u> | 14 |

PART III

| | |
|--|----|
| Item 9. <u>Directors, Executive Officers, Promoters and Control Persons; Compliance With Section 16(a) of the Exchange Act</u> | 15 |
| Item 10. <u>Executive Compensation</u> | 16 |
| Item 11. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u> | 18 |
| Item 12. <u>Certain Relationships and Related Transactions</u> | 19 |
| Item 13. <u>Exhibits</u> | 19 |
| Item 14. <u>Principal Accountant's Fees and Services</u> | 20 |
| <u>Signatures</u> | 21 |

Table of Contents

Index to Financial Statements

PART I

Item 1. Description of Business

THE COMPANY

Reliability Incorporated has principally been engaged in the design, manufacture, market and support of high performance equipment used to test and condition integrated circuits (Testing Products). Reliability also designed, manufactured and marketed a line of DC-DC power converters (Power Sources). Reliability and its subsidiary (collectively referred to as Reliability or the Company) also operated a service facility in Singapore that conditioned and tested integrated circuits as a service for others (Services).

During the past seven years, Reliability Incorporated and its subsidiaries (collectively referred to as Reliability or the Company) has sustained significant negative financial results, including substantial decreases in revenues, net income, backlog, and cash flows from operating activities that are generally attributable to operating losses. Due to the deterioration in its financial position, the Company has undergone significant restructuring to reduce its expenses and improve its liquidity, including: the closure of its Power Sources Costa Rica facility, significant downsizing of its domestic and international workforce, the sale of its Power Sources division, the closure of its Services division in Singapore, eliminated all research and development for test equipment, the sale of its Houston headquarters facility, and the closure of its Test Systems business. As a result of these actions, the Company significantly reduced its expenses, and generated some cash. However, based upon its current financial position, and an evaluation of the prospects for continuing to operate its historical business lines, the Company concluded that it should explore some other possibilities.

On April 1, 2007, Reliability completed the merger of its wholly owned subsidiary, Reliability-Medallion, Inc., a Florida corporation, into Medallion Electric Acquisition Corporation and the indirect acquisition, through Medallion Electric Acquisition Corporation, of Medallion Electric, Inc.

Medallion Electric Acquisition Corporation was incorporated under the laws of the State of Florida on December 8, 2006 to facilitate a merger between business entities and was considered to be a development stage company with no operations at March 31, 2007. On June 21, 2007, the Company changed the name of Medallion Electric Acquisition Corporation (MEAC) to Reliability Contractors of Florida, Inc. Reliability Contractors of Florida, Inc. is a wholly-owned subsidiary of Reliability.

Medallion Electric, Inc. (Medallion Electric or Medallion) was incorporated in the State of Florida in 1980. Medallion Electric is an electrical contracting company, located in Coral Springs, Florida, specializing in electrical contracting services to residential homebuilders, with its major assets consisting of contracts for services to be performed and accounts receivable. Medallion Electric became a wholly-owned subsidiary of Reliability Contractors of Florida, Inc. (collectively referred to as Reliability Florida or Electrical Contracting Services).

All of the funds used for the initial acquisition payment and the Company s transaction costs related to the merger and acquisition were paid out of the Company s cash on hand. The Company funded \$750,000 to finance the acquisition. \$100,000 of such funds was made available to Medallion Electric as working capital; \$150,000 was used by MEAC to pay its transaction related expenses. The remaining \$500,000 was used to make the initial payment to Mr. Ronald Masaracchio (Masaracchio), the only shareholder of Medallion Electric for 100% of the stock of Medallion Electric. The remainder of the purchase price consisted of two notes- one for \$500,000 due in six months and one for \$1.4 million due in six months. The Company secured the \$500,000 note with the pledge of its real property in North Carolina; the \$1.4 million note was secured with the assets of Medallion Electric.

The Company planned to pay the notes from the Company s working capital, funds generated by Electrical Contracting Services, additional debt and/or equity financing, and the sale of a part of its real estate located in North Carolina. However, in early September, 2007 it became apparent, the Company was not generating enough funds and had not been successful in raising debt or equity funds to meet all of the obligations which would be due on October 1, 2007. Therefore, the Reliability Board of Directors passed a resolution on September 25, 2007 that instructed management to enter into an agreement to sell Medallion Electric, Inc. back to the previous owner, Mr. Masaracchio.

Table of Contents

Index to Financial Statements

On October 12, 2007, the Company and its subsidiaries Reliability Contractors of Florida, Inc. and Medallion Electric, Inc. entered into a Settlement, Sale of Stock and Release Agreement (Agreement) with Mr. Masaracchio, pursuant to which Reliability Contractors sold back to Masaracchio the stock of Medallion effective October 1, 2007. The Company agreed to pay Mr. Masaracchio \$325,000 upon the closing of the sale of part of the Company s North Carolina real estate, which was under a purchase and sale contract, and transfer 100% of the Medallion stock to Masaracchio. Masaracchio agreed to release all the liens against the Company s assets, cancel all the notes, and release the Company from any and all of its obligations to him. In addition to the \$325,000, Reliability transferred to Masaracchio all the Medallion stock which held assets that were valued at approximately \$1.7 million on Reliability s balance sheet and liabilities which were generated in the normal course of business at Medallion valued at approximately \$529,000.

Upon the closing of the sale of a portion of Reliability s North Carolina real estate on October 26, 2007, Mr. Masaracchio received the \$325,000, and the sale of Medallion Electric, the release of the liens, and cancellation of all the obligations was consummated. At the time of the sale, Masaracchio held two notes totaling \$1.9 million, which were due October 1, 2007, and an earnout agreement which called for a minimum payment of \$750,000 over three years. The notes were secured by the assets of Medallion and the North Carolina property owned by Reliability. The sale of Medallion back to Masaracchio included a release of all liability on the notes and the earnout agreement, assumption of all Medallion ordinary course of business debts and obligations, mutual releases between Reliability and Masaracchio, including a release of the security for the notes. The net proceeds from the sale of a part of the North Carolina real estate to Reliability, after the \$325,000 payment and all other expenses of the sale, were \$292,000. The Company retained the ownership of 10 acres of land in North Carolina.

Upon the sale of Medallion Electric and cancellation of related liabilities, the Company s largest remaining asset is the 10 acres of land in North Carolina.

The Company was incorporated under the laws of the State of Texas in 1953, but the principal business of the Company, as described in this report, started in 1971, but was closed down in 2007. The Company has two wholly owned subsidiary, Reliability Singapore, Pte Ltd, and Medallion Electric Acquisition Corporation, which are not operating. The accompanying financial statements for twelve month period ended December 31, 2007, have been prepared assuming the Company will continue as a going concern. However, upon the completion of the sale of Medallion Electric, the Company has no further operating activities. The accompanying financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classifications of liabilities that may result from the possible inability of the Company to continue as a going concern.

However, based upon its current financial position, and an evaluation of the prospects for continuing to operate, the Company has concluded that it should pursue one, or some combination, of the following courses of action: sell its remaining real estate holdings; invest in another line of business through a purchase or merger; make distributions to its shareholders of the proceeds of asset or business line sale, 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.

The accompanying financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classifications of liabilities that may result from the possible inability of the Company to continue as a going concern.

Table of Contents

Index to Financial Statements

INDUSTRY OVERVIEW

Rapid technological advances resulting in evolving industry standards characterize the semiconductor industry. As the performance of semiconductors has increased and their physical size and cost per function have decreased, the demand for semiconductors has expanded not only in computer systems but also in telecommunications, automotive products, consumer goods and industrial automation and controls. The demand for smaller, faster, higher performance integrated circuits (ICs) continuously places new technical challenges and demands on semiconductor manufacturers and semiconductor equipment manufacturers to provide innovative new products and product enhancements to improve quality control and reduce manufacturing cost.

Under current semiconductor technology and manufacturing processes, manufacturers are unable to consistently produce batches of ICs that are completely free of defects that may cause the ICs to fail. An IC may be defective at the time it is produced or it may have a latent defect that eventually will cause it to fail. An IC with such a defect will almost always fail during the first 500-1000 hours of normal use. As a result, it has become customary to condition or burn-in ICs (i.e., to subject them, during a relatively short period of time, to controlled stresses which simulate the first several hundred hours of operation) to identify defects prior to delivery. Such conditioning subjects the ICs to maximum rated temperatures, voltages and electrical signals. Following burn-in, the ICs are tested to determine whether they function as designed.

PRODUCTS

During fiscal 2006, the Company had three operating segments based on its product and service offerings: Testing Products, Services and Power Sources. In March of 2006, the Company sold its Power Sources segment and in April of 2006 the Company commenced the closure of its Services segment. In March of 2007, the Company closed its Testing Products segment, and purchased Medallion Electric, Inc., an electrical contractor located in Florida, on April 1, 2007. On October 1, 2007, the Company sold Medallion Electric, Inc. back to its previous owner. As a result of these actions, all the Company's operating segments are reported as discontinued operations in the accompanying Financial Statements for each period presented. See Note 3 of Notes to Consolidated Financial Statements for financial information regarding discontinued operations reporting.

TESTING PRODUCTS

The Company has been providing capital equipment to IC manufacturers and users to burn-in ICs since 1975 and to functionally test ICs during burn-in since 1980. The Company was one of the first to design, manufacture and market systems that utilize burn-in and test technology within the same product. From 1992 to 2001, the Division focused its research and development activities on equipment and related software that perform functional testing during burn-in of memory devices (i.e., DRAM, SRAM, SDRAM) and micrologic devices (i.e., microprocessors). This focus led to the development of two major product families: INTERSECT for performing functional and long cycle tests on large quantities of memory devices in parallel during the conditioning (burn-in) process; and CRITERIA® 18 designed for fine-line geometry micrologic devices (i.e., microprocessors) that dissipate large amounts of heat.

From 2001 through August 2005, the Division's focus was on developing its newest generation burn-in and test system for medium and high power micrologic devices, the CRITERIA 20. During this period, the Division spent in excess of \$5 million on the development of the Criteria 20. Despite actively marketing the Criteria 20 during this period, the Company was unable to secure an order for a Criteria 20 unit. As a result of the continued lack of demand for the product and the high level of expenditures necessary to continue to develop the product, the Company suspended research and development activities and significantly reduced its workforce in August 2005. Since that time, the business activity of the Testing Products Division has consisted of sales of spare parts for, and the refurbishment and upgrades to, existing, previous generation systems. The Company closed down the remaining part of its Testing Products segment in March of 2007.

Table of Contents

Index to Financial Statements

SERVICES

The Company has provided burn-in and other related services to its customers since 1971. The establishment or expansion of a service facility requires a large investment of capital. Although the Company and its customers have historically shared capital cost, the Company is primarily responsible for providing the building and equipment required, along with the personnel and management to operate the facility.

The Company operated a service facility in Singapore that used CRITERIA and INTERSECT systems to provide burn-in and burn-in test services for DRAM, SDRAM, SRAM, and microprocessors. The Company also used related equipment acquired from others to provide serial testing, laser-marking, and tape and reel services.

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 maintained a small number of employees to complete unfinished jobs, provide limited services for its customers while they seek alternative service providers, prepare equipment for sale and vacate the division's leased facility. The liquidation of the Company's former Services division was substantially complete as of December 31, 2006. The complete dissolution of this division is expected to be complete during the first half of 2008. The Company's former Services division is reported as discontinued operations in the accompanying Financial Statements for each period presented. **See Note 3** of the Notes to Consolidated Financial Statements for information regarding discontinued operations.

POWER SOURCES

The operating components of electronic equipment frequently have varying electrical requirements. Rather than provide power to each component separately, specialized power devices called DC-DC converters, or power sources, are used to convert direct current voltage into a higher or lower voltage. By using small DC-DC converters, electronic equipment can operate from a single output power supply yet provide different voltages to different operating components, allowing designers of electronic equipment to localize power requirements, increase modularity in the product design and expand equipment features without having to redefine power needs. The Company offered a wide range of DC-DC converters from 1 to 30 Watts targeting customers within the telecommunications, computer and other industries.

On March 14, 2006, the Company sold its Power Sources Division to Reliability Power, Inc., an unaffiliated third party. The Company's former Power Sources division is reported as discontinued operations in the accompanying Financial Statements for each period presented. **See Note 3** of the Notes to Consolidated Financial Statements for financial information regarding discontinued operations.

SALES AND MARKETING

The Company has historically maintained direct sales and service operations in the United States and Singapore as well as a network of distributors and sales representative in certain other key areas within the United States, Europe and Southeast Asia. Due to the sale of the Company's former Power Sources division, the closure of its Services division in Singapore and an evaluation of the prospects for continuing to operate its remaining business line, the Company no longer maintains direct sales or service operations.

RESEARCH AND DEVELOPMENT

The semiconductor industry's and the electronic equipment industry's demand for increasingly complex and sophisticated equipment requires innovation and accurate anticipation of changing needs and emerging technology trends. To avoid becoming technologically obsolete over time, the Company has historically committed a significant portion of its resources to research and development programs for new products and enhancements to existing products.

In August 2005, as a part of cost cutting measures, the Company suspended all research and development activities. As a result, the Company's research and development expenditures were nil in 2006 and 2007.

The Company has no present plans to resume research and development activities.

Table of Contents

Index to Financial Statements

INTELLECTUAL PROPERTY

The Company believes that rapidly changing technology in the electronics industry makes the Company's future success dependent on the quality of its products and its ability to adapt to the changing technological requirements more than upon the protection of any proprietary rights.

Although the Company believes that its intellectual property may have some value, no single item is, in itself, critical to the Company's business. Therefore, the Company has no plans to continue to protect its intellectual property through patents, copyrights, trade secrets, trademarks, and other means.

RAW MATERIALS AND INVENTORY

The Company discontinued its operating activities during 2007. Thus, the Company has no inventory and no plans to purchase any inventory.

CUSTOMERS AND COMPETITION

The Company no longer has a customer base nor does it remain in a competitive market.

EMPLOYEES

As of December 31, 2007, the Company no longer has any full time paid employees. The Company contracts any work that must be done. None of the Company's employees are represented by a labor union.

INTERNATIONAL OPERATIONS

The Company is domiciled in the United States and previously sold products to customers for delivery outside of the U.S. However, as discussed above, the Company discontinued its last foreign operation (Singapore) in 2006 and only has winding down activities remaining.

ENVIRONMENTAL MATTERS

The Company does not expect to be affected by zoning, environmental protection, or other similar laws or ordinances.

SEASONALITY

The Company no longer has any operating activities.

GOVERNMENTAL BUSINESS

The Company does not have any business with any governmental agencies.

Table of Contents

Index to Financial Statements

Item 2. Description of Properties

In June 2006, the Company completed the sale of its former headquarters and principal administrative, engineering and manufacturing facility located in Park 10, an office and industrial park located on the west side of Houston, Texas. The Company relocated its headquarters to a 3,400 square foot leased facility, also located in Park 10, on the west side of Houston. The Company vacated this lease September 30, 2007.

The Company also owned a 43,500 square foot facility on a seventeen-acre tract of land in Durham, North Carolina. The Company sold approximately 7.5 acres and the 43,500 sq ft facility in October, 2007, for \$675,000. Three Hundred Twenty-five Thousand (\$325,000) of the proceeds from the sale was used as part of the payment made to the former owner of Medallion Electric, Inc. See Note 4 of the Notes to the Consolidated Financial Statements. The Company's proceeds from the sale was a net of \$292,000. The Company still owns the remaining 10 acres of land which it is actively marketing.

Item 3. Legal Proceedings.

Not applicable.

Item 4. Submission of Matters to a Vote of Security Holders.

Not applicable.

Table of Contents**Index to Financial Statements****PART II****Item 5. Market for Common Equity, Related Stockholder Matters and Small Business Issuer Purchases of Equity Securities.**

The Company's common stock trades in the over-the-counter bulletin board market under the symbol REAL. Prior to February 24, 2005, the Company's stock traded on Nasdaq, until no longer meeting its listing requirements. The high and low sale prices for 2006 and 2007 are set forth below.

| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
|------|------------------|-------------------|------------------|-------------------|
| 2007 | | | | |
| High | \$.23 | \$.30 | \$.27 | \$.14 |
| Low | .17 | .19 | .10 | .05 |
| 2006 | | | | |
| High | \$.29 | \$.31 | \$.28 | \$.22 |
| Low | .16 | .18 | .18 | .18 |

The price information provided above was obtained from MSN.com and is based upon inter-dealer quotes without retail mark-ups, mark-down or commissions and may not necessarily reflect actual sale transactions.

The Company paid no cash dividends in 2007 or 2006 and had approximately 500 shareholders of record as of December 31, 2006, and 470 shareholders of record as of December 31, 2007, not counting the shareholders who hold the Company stock in street name.

The following table sets forth the number of shares of the Company's common stock reserved for issuance under the Company's equity compensation plans as of December 31, 2007:

| Plan category | Number of securities to be issued upon exercise of outstanding options, warrants and rights (a) | Weighted-average exercise price of outstanding options, warrants and rights (b) | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c) |
|---|---|---|---|
| Equity compensation plans approved by security holders | 370,000 | \$ 0.21 | 0 |
| Equity compensation plans not approved by security holders | | | |
| Total | 370,000 | \$ 0.21 | 0 |

Shares of Company stock were also used to fund the matching feature of the Employee Stock Savings Plan, which was terminated effective November 16, 2006. See Note 7 to the Company's Consolidated Financial Statements for information concerning Employee Stock Savings Plan.

No shares of common stock were sold during 2006 or 2007 that were not registered under the Securities Act. All the shares issued under the agreement to purchase Medallion Electric in 2007 were returned to the Company. No shares of common stock were repurchased by the Company or any of its affiliates in 2006 or 2007.

Table of Contents

Index to Financial Statements

Item 6. *Management's Discussion and Analysis or Plan of Operation.*

The following discussion and analysis of financial condition and results of operations of the Company should be read in conjunction with the Consolidated Financial Statements and related notes that appear in this document.

REVIEW OF SIGNIFICANT ACCOUNTING POLICIES

In response to a guidance document that was issued by the Securities and Exchange Commission, the Company completed a review of its significant accounting policies. The results of the review indicated that the accounting policies that the Company has adopted are appropriate for the operations of the Company and that the Company has correctly applied the accounting policies. **See Note 1** to the Company's Consolidated Financial Statements for information concerning significant accounting policies.

Management's discussion and analysis of its financial condition and results of operations is based on the Company's Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and the related disclosure of contingent assets and liabilities, if any exist. The Company evaluates its estimates on an on-going basis, including those related to inventories, investments, assets held for sale, intangible assets, income taxes, warranty obligations, bad debts, product returns, long-lived assets and contingencies, if any. The Company bases its estimates on historical experience and various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values and disclosure of amounts recorded or disclosed in the Consolidated Financial Statements of the Company.

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 to 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 an acceptable 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.

Table of Contents

Index to Financial Statements

ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

During the past seven years, Reliability Incorporated and its subsidiaries (collectively referred to as Reliability or the Company) has sustained significant negative financial results, including substantial decreases in revenues, net income, backlog, and cash flows from operating activities that are generally attributable to operating losses. Due to the deterioration in its financial position, the Company has undergone significant restructuring to reduce its expenses and improve its liquidity, including: the closure of its Power Sources Costa Rica facility, significant downsizing of its domestic and international workforce, the sale of its Power Sources division, the closure of its Services division in Singapore, eliminated all research and development for test equipment, the sale of its Houston headquarters facility, and the closure of its Test Systems business. As a result of these actions, the Company significantly reduced its expenses, and generated some cash. However, based upon its current financial position, and an evaluation of the prospects for continuing to operate its historical business lines, the Company concluded that it should explore some other possibilities.

On April 1, 2007, Reliability completed the merger of its wholly owned subsidiary, Reliability-Medallion, Inc., a Florida corporation, into Medallion Electric Acquisition Corporation and the indirect acquisition, through Medallion Electric Acquisition Corporation, of Medallion Electric, Inc.

Medallion Electric Acquisition Corporation was incorporated under the laws of the State of Florida to facilitate a merger between business entities and was considered to be a development stage company with no operations at March 31, 2007. On June 21, 2007, the Company changed the name of Medallion Electric Acquisition Corporation (MEAC) to Reliability Contractors of Florida, Inc. Reliability Contractors of Florida, Inc. is a wholly-owned subsidiary of Reliability.

Medallion Electric, Inc. (Medallion Electric or Medallion) was incorporated in the State of Florida in 1980. Medallion Electric is an electrical contracting company, located in Coral Springs, Florida, specializing in electrical contracting services to residential homebuilders, with its major assets consisting of contracts for services to be performed and accounts receivable. Medallion Electric is a wholly-owned subsidiary of Reliability Contractors of Florida, Inc. (collectively referred to as Reliability Florida or Electrical Contracting Services).

All of the funds used for the initial acquisition payment and the Company s transaction costs related to the merger and acquisition were paid out of the Company s cash on hand. The Company funded \$750,000 to finance the acquisition. \$100,000 of such funds was made available to Medallion Electric as working capital; \$150,000 was used by MEAC to pay its transaction related expenses. The remaining \$500,000 was used to make the initial payment to Mr. Ronald Masaracchio (Masaracchio), the only shareholder of Medallion Electric for 100% of the stock of Medallion Electric. The remainder of the purchase price consisted of two notes- one for \$500,000 due in six months and one for \$1.4 million due in six months. The Company secured the \$500,000 note with the pledge of its real property in North Carolina; the \$1.4 million note was secured with the assets of Medallion Electric.

The Company planned to pay the notes from the Company s working capital, funds generated by Electrical Contracting Services, additional debt and/or equity financing, and the sale of a part of its real estate located in North Carolina. However, in early September, 2007 it became apparent, the Company was not generating enough funds and had not been successful in raising debt or equity funds to meet all of the obligations which would be due on October 1, 2007. Therefore, the Reliability Board of Directors passed a resolution on September 25, 2007 that instructed management to enter into an agreement to sell Medallion Electric, Inc. back to the previous owner, Mr. Masaracchio.

On October 12, 2007, the Company and its subsidiaries Reliability Contractors of Florida, Inc. and Medallion Electric, Inc. entered into a Settlement, Sale of Stock and Release Agreement (Agreement) with Mr. Masaracchio, pursuant to which Reliability Contractors sold back to Masaracchio the stock of Medallion effective October 1, 2007. The Company agreed to pay Mr. Masaracchio \$325,000 upon the closing of the sale of part of the Company s North Carolina real estate, which was under a purchase and sale contract, and transfer 100% of the Medallion stock to Masaracchio. Masaracchio agreed to release all the liens against the Company s assets, cancel all the notes, and release the Company from any and all of its obligations to him. In addition to the \$325,000, Reliability transferred to Masaracchio all the Medallion stock which held assets that were valued at approximately \$1.7 million on Reliability s balance sheet and liabilities which were generated in the normal course of business at Medallion valued at approximately \$529,000.

Table of Contents

Index to Financial Statements

Upon the closing of the sale of a portion of Reliability's North Carolina real estate on October 26, 2007, Mr. Masaracchio received the \$325,000, and the sale of Medallion Electric, the release of the liens, and cancellation of all the obligations was consummated. At the time of the sale, Masaracchio held two notes totaling \$1.9 million, which were due October 1, 2007, and an earnout agreement which called for a minimum payment of \$750,000 over three years. The notes were secured by the assets of Medallion and the North Carolina property owned by Reliability. The sale of Medallion back to Masaracchio included a release of all liability on the notes and the earnout agreement, assumption of all Medallion ordinary course of business debts and obligations, mutual releases between Reliability and Masaracchio, including a release of the security for the notes. The net proceeds from the sale of a part of the North Carolina real estate to Reliability, after the \$325,000 payment and all other expenses of the sale, were \$292,000. The Company retained the ownership of 10 acres of land in North Carolina.

Net cash used by operating activities for the year ended December 31, 2006 was \$1,544,000, compared to \$385,000 used by operations during 2007. The principal items contributing to the \$385,000 useage of cash in 2006 was the net income of \$1,583,000 from the gain on the sale of assets, primarily the sale of the Company's headquarters facility, which drove the net income for 2006 to \$204,000. The principal items contributing to the net cash used by operations in 2007 was a net loss from continuing operations of \$616,000. Changes in depreciation & amortization; inventory obsolescence provisions, and changes in operating assets and liabilities including decline in accounts receivable and decreases in prepaid expenses, accounts payable, and accrued liabilities almost offset each other.

In 2006 investing activities provided \$4,616,000 as a result of net proceeds of, \$3,866,000 on the sale of the Company's headquarters facility, \$300,000 from the sale of the Company's former Power Sources segment, \$242,000 from the sale of excess furniture and equipment, and \$208,000 from the sale of investment securities. In 2007 the Acquisition of businesses, specifically Medallion Electric, reduced cash by \$787,000.

Financing activities used \$2,556,000 in 2006, primarily the result of the Company repaying all borrowing under its former credit agreement upon the sale of its headquarters facility in comparison to only \$53,000 used in financing activities in 2007.

The Company was incorporated under the laws of the State of Texas in 1953, but the principal business of the Company, as described in this report, started in 1971, but was closed down in 2007. The Company has two wholly owned subsidiary, Reliability Singapore, Pte Ltd, and Medallion Electric Acquisition Corporation which are not operating. The accompanying financial statements for twelve month period ended December 31, 2007, have been prepared assuming the Company will continue as a going concern. However, upon the completion of the sale of Medallion Electric, the Company has no further operating activities. The accompanying financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classifications of liabilities that may result from the possible inability of the Company to continue as a going concern.

However, based upon its current financial position, and an evaluation of the prospects for continuing to operate, the Company has concluded that it should pursue one, or some combination, of the following courses of action: sell its remaining real estate holdings; invest in another line of business through a purchase or merger; make distributions to its shareholders of the proceeds of asset or business line sale, 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.

The accompanying financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classifications of liabilities that may result from the possible inability of the Company to continue as a going concern.

Available sources of liquidity at December 31, 2007 include cash and cash equivalents of \$32,000, and assets held for sale of \$225,000. See **Note 4** to the Company's Consolidated Financial Statements for information regarding assets held for sale.

Table of Contents

Index to Financial Statements

RESULTS OF CONTINUING OPERATIONS

Net Revenues and Gross Profit

Revenues and gross profit for 2006 and 2007 from continuing operations are reported as zero for both years, as all operations were discontinued as of September 30, 2007 and the financial statements show all operations for 2006 and 2007 as discontinued operations. See **NOTE 3** of the Notes to the Consolidated Financial Statements.

Marketing, General and Administrative

Marketing, general and administrative (MG&A) expenses primarily consist of employee salaries and payroll related costs, insurance, rent, and legal, accounting and other professional services.

MG&A expenses decreased from \$1,301,000 in 2006 to \$483,000 in 2007. The reductions were primarily the result of a decrease in payroll related costs from \$740,000 in 2006 to \$384,000 in 2007 as the result of salary cuts and staff reductions. A reduction in rent of \$48,000 and a \$61,000 decrease in corporate compliance and professional fees further reduced the MG&A.

The reductions were partially offset by an impairment charge of \$159,000 related to the North Carolina property which was carried as an Asset held for sale. See **Note 4** of the Notes to the Company's Consolidated Financial Statements.

Gain on the Sale of Assets

In June of 2006, the Company sold its Houston headquarters facility, 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 and recognized a gain on the sale of approximately \$1.4 million. In addition, the Company recorded a gain of \$88,000 on the sale of excess idle equipment and furnishings in its Houston facility and a \$59,000 gain on the sale of securities.

In 2007 the Company recorded a gain of \$3,000 on the sale of excess equipment and furnishings.

Interest Expense

Interest expense for 2006, as a result of borrowing under the Company's former credit agreements, was \$170,000. The Company repaid all its credit agreement debt as of June 30, 2006, and paid no interest in 2007.

Loss from discontinued operations

The loss from discontinued operations increased from \$382,000 in 2006 to \$1,377,000 in 2007. The loss in 2006 was due to the loss on the closing of the Services segment. The \$1,377,000 loss in 2007 was primarily due to a loss of \$1,150,000 from the purchase and later sale of Medallion Electric, Inc during 2007. See **Note 3** to the Company's Consolidated Financial Statements for information regarding gains and losses from discontinued operations.

Provision for Income Taxes

The Company recorded no provision or benefit for income taxes in 2006 or 2007 due to its substantial cumulative operating losses. See **Note 5** to the Company's Consolidated Financial Statements for information regarding income taxes

OFF-BALANCE SHEET ARRANGEMENTS

None.

Item 7. *Financial Statements.*

The financial statements of the Company and the related report of the Company's independent registered public accounting firm thereon are included in this report and are referenced as pages F-1 to F-16.

Item 8. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.*

None

Table of Contents

Index to Financial Statements

Item 8A. Controls and Procedures.

(a) *Evaluation of Disclosure Controls and Procedures.* Our management, with the participation of our Chief Executive Officer (CEO), evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, our CEO concluded that our disclosure controls and procedures as of the end of the period covered by this report were effective such that the information required to be disclosed by us in reports filed under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) accumulated and communicated to our management, including our CEO, as appropriate to allow timely decisions regarding disclosure. A controls system cannot provide absolute assurance, however, that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

Management's Annual Report on Internal Control over Financial Reporting. Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act). Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes of accounting principles generally accepted in the United States.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance of achieving their control objectives.

Our management, with the participation of the CEO, evaluated the effectiveness of the Company's internal control over financial reporting as of December 31, 2007. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control - Integrated Framework. Based on this evaluation, our management, with the participation of the President, concluded that, as of December 31, 2007, our internal control over financial reporting was effective.

(b) *Changes in Internal Control over Financial Reporting.* There were no changes in the Company's internal controls over financial reporting, known to the chief executive officer that occurred during the period covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Item 8B. Other Information

Not applicable.

Table of Contents**Index to Financial Statements****PART III**

Item 9. Directors and Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act.
Directors of the Company at December 31, 2007 were as follows:

Other positions and offices presently held with the Company (and

| Name | Director since | Age | other principal occupation, if different |
|--------------------|-----------------------|------------|---|
| Larry Edwards | 1995 | 66 | Chairman of the Board of Directors, President and Chief Executive Officer |
| Thomas L. Langford | 1980 | 66 | (Group Vice President, Consolidated Contractors International Co. S.A.L.) |
| Philip Uhrhan | 1997 | 58 | (Retired) |
| C. Lee Cooke, Jr | 2004 | 63 | (President, Chief Executive Officer, Habitek International, d/b/a U.S. Medical Systems, Inc.) |
| David C. Kurland | 2007 | 47 | Chief Counsel, Sunco, Inc. |

Mr. Edwards has been President and Chief Executive Officer of the Company since 1993 and has been a Director and Chairman of the Board of Directors since 1995. From 1990 to 1993, he served as President and Chief Operating Officer of the Company. Mr. Edwards joined the Company in 1977 as Manager of Engineering, Planning and Manufacturing Systems, and subsequently held the positions of Vice President Operations, Corporate Vice President Systems, and Executive Vice President Systems.

Mr. Langford has been a Director of the Company since 1980. Mr. Langford's principal occupation has been that of Group Vice President of Consolidated Contractors International Co. S.A.L., an engineering and construction company, since February 2001. He was Executive Vice President of Stone and Webster, Inc., a professional engineering, construction and consulting company, from 1997 to July 2000. In June 2000, Stone and Webster, Inc. filed a Chapter 11 Bankruptcy, and Mr. Langford served, from July 2000 until January 2001 as President and Chief Restructuring Officer of the Debtor in Possession of Stone and Webster. From 1991 until 1996, Mr. Langford was President of Parsons Corporation, an engineering and construction company.

Mr. Uhrhan has been a Director of the Company since 1997. Mr. Uhrhan is retired. He served as Vice President Finance of Solvay America, Inc., a chemical and pharmaceuticals company, from 1996 until February of 2007. Mr. Uhrhan was a Partner with Ernst & Young LLP for more than five years prior to his employment by Solvay America, Inc.

Mr. C. Lee Cooke, Jr. has been a director of the Company since July 2004. Since 1991, he has been President and Chief Executive Officer of Habitek International, Inc. d/b/a U.S. Medical Systems, Inc., a biomedical company. He served as Chairman of the Board, Chief Executive Officer and President of Sharps Compliance Corp. from March 1992 until July 1998. Mr. Cooke served as Chairman of the Board for Tanisys Technology, Inc. (Tanisys), a developer and marketer of semi-conductor testing equipment from February 2002 until February 2003 and served as Chief Executive Officer from March 2002 until February 2003. Mr. Cooke serves as an advisory director to the Staubach Group, CTLLC, a real estate representative company. Mr. Cooke also serves on the board of two other private companies. Mr. Cooke was President and Chief Executive Officer of CUville, Inc., d/b/a Good2CU.com, from 1999 until 2000. Mr. Cooke served as Chief Executive of The Greater Austin Chamber of Commerce from 1983 to 1987. From 1972 to 1983, Mr. Cooke also served in various management roles with Texas Instruments. From 1988 to 1991 he served in the elected position of Mayor of Austin, Texas. Mr. Cooke has served as director of New Century Equity Holdings Corp. (New Century), a publicly-held holding company focused on high growth companies since 1996.

Mr. David C. Kurland has been a Director of the Company since April, 2007. Since 2001, Mr. Kurland has served as Chief Counsel with Sunco, Inc. (R&M), a major refining and chemical company, where he is responsible for regulatory and corporate compliance matters. From 1992 to 2001, Mr. Kurland was Chief Counsel at Rohm and Haas. From 1989 to 1992, he practiced law with a mid-size law firm in Philadelphia, Pennsylvania.

Directors serve a one-year term and hold office until their successors are elected by the shareholders, unless they shall sooner resign.

The Company has an Audit Committee comprised of its four independent directors, Messrs. Langford, Uhrhan, Kurland, and Cooke. The Board has determined that the Company has two audit committee financial experts, as defined by the Securities and Exchange Commission, serving on its audit committee. Mr. Uhrhan, Chairman of the committee, and Mr. Langford qualify as financial experts and both are independent, as

independence for audit committee members is defined by the Securities and Exchange Commission.

Table of Contents**Index to Financial Statements**

Executive officers of the Company as of December 31, 2007 were as follows:

| Name | Age | Officer of Reliability Incorporated Since | Position Currently Held with Reliability Incorporated |
|---------------|-----|---|---|
| Larry Edwards | 66 | 1981 | Chairman of the Board of Directors, President and Chief Executive Officer |

Mr. Edwards has been President and Chief Executive Officer of the Company since 1993 and became a Director and Chairman of the Board of Directors in 1995. Mr. Edwards has been employed by the Company in various capacities since 1977.

Mr. James Harwell was appointed Executive Vice President and Chief Operating Officer in July 2003. From November 2002 until July 2003 and from August 2006 to November, 2007, he also served as Executive Vice President and Acting Chief Financial Officer. Mr. Harwell was employed by the Company in various capacities since 1979. Mr. Harwell resigned from the Company in November, 2007.

The Company has a code of ethics that applies to all directors, officers and employees, including its principal executive officer and principal financial officer (who is also its principal accounting officer).

The Company intends to post on its website any amendments to, or waivers from its code of ethics promptly following any such amendment or waiver. No amendments or waivers were granted in 2006 or 2007.

Item 10. *Executive Compensation.*
Summary compensation table

The following table provides information as to the compensation paid by the Company to its executive officers during fiscal years 2007 and 2006.

| (a) Name and principal position | (b) Year | (c) Salary | Annual compensation | | (j) Total |
|---|-------------|---------------|----------------------|-------------------------------|--------------|
| | | | (f) Option Awards | (i) All other Compensation | |
| Larry Edwards President, Chairman of the Board and Chief Executive Officer | 2007 | \$ 77,972 | \$ 0 | \$ 105,952 | \$ 183,924 |
| | 2006 | \$ 117,685 | \$ 24,000 | \$ 2,158 | \$ 143,843 |
| James M. Harwell Executive Vice President and Acting Chief Financial Officer | 2007 | \$ 95,860 | \$ 0 | \$ 61,545 | \$ 157,405 |
| Mr. Harwell resigned from the Company in November, 2007. | 2006 | \$ 103,872 | \$ 12,000 | \$ 1,598 | \$ 117,470 |

The Company has no employment contracts, long-term compensation plans, awards, defined benefit plans, stock appreciation rights or option plans except for the Amended and Restated 1997 Stock Option Plan. The Company has termination of employment or change in control agreements with its executive officers consisting of one weeks base pay for each year of service plus two weeks base pay. The Company paid \$105,952 to Mr. Edwards and \$61,545 to Mr. Harwell upon stopping to pay all salaries, which is shown in column (i) for 2007.

In addition to base salary, the Company has an incentive bonus plan which applies to the CEO, all executive officers, directors and all salaried employees of the Company. The incentive plan has three components:

1. a quantitative measure of the Company's performance based on income before income tax; and
2. a qualitative measure of each individual's performance during the year; and

Edgar Filing: RELIABILITY INC - Form 10KSB

3. a target incentive which is a quantitative percent of base salary.

The Company was not profitable during 2006 or 2007; therefore, no bonuses were paid. As a result column (d) is intentionally omitted in the compensation table above.

Table of Contents**Index to Financial Statements**

Under the Company's Amended and Restated 1997 Stock Option Plan (Option Plan), which expired in 2006, stock option grants were available for officers, directors, and key employees. The objective of the Option Plan was 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 acted as the Plan Administrator, determined to whom options were granted, the type of options, the number of shares covered by such options and the option vesting schedule. All options were issued at market value on the date of the grant and generally had a ten-year contractual term with graded vesting.

The amounts shown in column (f) represent the grant date fair value estimate of options granted during the last two completed fiscal years to the named individuals. See Note 8 to the Company's Consolidated Financial Statements for information concerning the Stock Options.

The Company sponsored an Employee Stock Savings Plan (the Plan), until November 16, 2006, when the Plan was terminated. The Plan allowed all U.S. employees, who had been employed for six months, to contribute up to 100% of defined compensation to the Plan. The Company matched employee contributions at a rate equal to 50% of the employee's contributions, but limited to 2% of the employee's defined compensation. In addition, the Company contributed an amount equal to 1% of defined compensation to all plan participants. The Plan also provided for the Company to make additional voluntary profit sharing contributions based on the consolidated profits of the Company. The Company did not make any additional voluntary profit sharing contribution in 2007, 2006 or 2005. See Note 7 to the Company's Consolidated Financial Statements for information regarding the Employee Stock Savings Plan.

The amounts shown in column (i) for 2006 represent the Company's matching contributions to the Employee Stock Savings Plan for the benefit of the named individuals. There were no payments in 2007.

Outstanding equity awards

The following table discloses information regarding all option awards, to executive officers, to purchase the Company's Common Stock as of December 31, 2007.

| Name | Option Awards | | | |
|----------------|---|---------------------|----------------|------------------------|
| | Number of Securities Underlying Unexercised Options | | Exercise Price | Option Expiration Date |
| | # Exercisable | # Unexercisable (1) | | |
| (a) | (b) | (c) | (e) | (f) |
| Larry Edwards: | 200,000 | | \$.21 | 7/19/2016 |
| James Harwell: | 100,000 | | \$.21 | 7/19/2016 |

(1) All issued options are vested and became exercisable on January 20, 2007.

Director Compensation

The following table provides information as to the compensation paid by the Company to each of its non-employee directors during fiscal year 2007.

| Name | Fees Earned or | Option | Total |
|----------------------------|----------------|--------|----------|
| | Paid in Cash | Awards | |
| (a) | (b) | (c) | (h) |
| Each non-employee director | \$ 9,350 | | \$ 9,350 |

The amount shown in column (c) represents the grant date fair value estimate of options granted during 2007 to each non-employee director. Since no options were granted in 2007 column (c) is blank. The payment to Mr. Kurland was slightly less since he did not serve as a director the first three months of 2007. See Note 8 to the Company's Consolidated Financial Statements for information concerning the Stock Options.

Table of Contents**Index to Financial Statements****Item 11. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**
Principal shareholders

Based on information available to the Company each of the following persons or groups beneficially owned 5% or more of the 6,335,965 shares of common stock outstanding as of March 18, 2007.

| Name and Address of Beneficial Owner | Amount and Nature of Beneficial Ownership | Percent of Class |
|--|---|------------------|
| Minerva Group, L.P. 50 Monument Road, Suite 201, Bala Cynwyd, PA 19004 | 457,000 | 7.21% |
| Gregg Schneider 10445 Wilshire Blvd., #1806, Los Angeles, CA 90024 | 412,500 | 6.51% |
| Jay Gottlieb 27 Misty Brook Lane, New Fairfield, CT 06812 | 507,220 | 8.01% |
| The Company's Employees Stock Savings Plan (the "Plan") was terminated effective November 16, 2006. The Plan owned a total of 412,625 shares (6.5% of the 6,335,965 shares of common stock outstanding as of December 31, 2006) of Common Stock. All the shares have been distributed to the owner of the shares or his designated plan as of March 25, 2008. No Plan participant owned 5% or more of the Company's shares through the Plan. See Note 7 to the Company's Consolidated Financial Statements for information concerning the Employee Stock Savings Plan. | | |

Security ownership of management

As of December 31, 2007, the amount of common stock owned by the directors of the Company, each executive officer named in the compensation table and all directors and officers as a group is shown in the table below. The business address of each named person is P.O. Box 218670, Houston, Texas 77218.

| Name of individual or group | Amount and Nature of Beneficial Ownership (1), (2) | Percent of Class (3) |
|---|--|----------------------|
| Larry Edwards | 422,785 | 6.21% |
| C. Lee Cooke, Jr | 15,000 | .22 |
| Thomas L. Langford | 35,000 | .52 |
| Philip Uhrhan | 20,000 | .29 |
| James M. Harwell | 175,828 | 2.58 |
| All executive officers and directors as a group | 668,613 | 9.82% |

- (1) Each person has the sole power to vote and sell the shares shown in this column except that Mr. Edwards has shared power with his spouse to vote and sell 61,200 of the shares reported above.
- (2) Includes the following number of stock options: Mr. Edwards, 200,000; Mr. Cooke, 15,000 shares; Mr. Langford 15,000 shares; Mr. Uhrhan, 15,000 shares; Mr. Harwell 100,000 shares; all directors and executive officers as a group 345,000 shares.
- (3) The percent stated in this column is based on the total beneficial ownership of the individual or group as a percent of the 6,335,965 shares of Common Stock outstanding as of December 31, 2007, plus the 470,000 shares acquirable under stock options on, or within 60 days of, December 31, 2007.

Edgar Filing: RELIABILITY INC - Form 10KSB

On April 1, 2007, the Company consummated a merger of its wholly owned subsidiary, Reliability-Medallion, Inc., a Florida corporation, into Medallion Electric Acquisition Corporation, a Florida corporation, and the indirect acquisition, through Medallion Electric Acquisition Corporation, of Medallion Electric, Inc., a Florida corporation. As part of the transaction, the Company issued 2,850,000 unregistered restricted shares of its common stock to the shareholders of Medallion Electric Acquisition Corporation as consideration for the Merger and 150,000 unregistered restricted shares of its common stock in connection with Medallion Electric Acquisition Corporation's acquisition of Medallion Electric. Under the Agreement of Merger and Plan of Reorganization, the Company was required to raise capital of a minimum of \$2 million in one or more private placements of common stock to select accredited investors by June 15, 2007. Since the minimum of \$2,000,000 was not raised in such private placements by June 15, 2007, the 3,000,000 shares issued in connection with the merger and acquisition were forfeited and returned to the treasury.

Table of Contents

Index to Financial Statements

Item 12. *Certain Relationships and Related Transactions.*

Not applicable.

Item 13. *Exhibits*

a) The following financial statements are filed as part of this report:

1. Consolidated Financial Statements: Listed in the Index to Financial Statements provided in response to Item 7 hereof (see p. F-1 for Index)
2. Financial Statement Schedule. Financial Statement schedules are omitted because they are inapplicable or the required information is shown in the financial statements or noted therein.

b) The following exhibits are filed as part of this report:

- 3.1 Restated Articles of Incorporation (with amendment). Reference is made to Exhibit 3 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 1995.
- 3.2 Restated Bylaws. Reference is made to Exhibit 3.2 to the Company's Annual Report on Form 10-K for the year ended December 31, 2003.
- 3.3 Amended Bylaws. Reference is made to Exhibit 3.01 of the Company's Form 8-K, filed on April 6, 2007.
- 10.1 Agreement of Merger and Plan of Reorganization. Reference is made to Exhibit 2.01 to the Company's Form 8-K filed on April 6, 2007.
- 10.2 Stock Purchase Agreement. Reference is made to Exhibit 2.02 to the Company's Form 8-K filed on April 6, 2007.
- 21 List of Subsidiaries.
- 23 Consent of Independent Registered Public Accounting Firm.
- 31.1 Certifications Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act.
- 32 Certifications Pursuant to Rule 13a-14(b)/15d-14(b) and Section 1350, Chapter 63, Title 18 of the United States Code

Table of Contents**Index to Financial Statements****Item 14. *Principal Accountant's Fees and Services*
Fees Paid to Principal Accounting Firm**

Aggregate fees of Reliability to Fitts, Roberts & Co., P.C. for fiscal year 2007 and 2006 are listed below:

| Fee category | 2007 | 2006 |
|---------------------|------------------|------------------|
| Audit fees | \$ 59,925 | \$ 46,600 |
| Audit-related fees | | |
| Tax fees | 12,400 | 9,400 |
| All other fees | 6,975 | |
| Total fees | \$ 79,300 | \$ 56,000 |

Audit Fees: Consists of fees billed for professional services rendered for the audit of Reliability's consolidated financial statements and review of the interim consolidated financial statements included in quarterly reports and services that are normally provided by its independent registered public accounting firm.

Audit-Related Fees: Consists of fees billed for assurance and related services that are reasonably related to the performance of the audit or review of Reliability's consolidated financial statements and are not reported under *Audit Fees*. These services include employee benefit plan audits and consultations concerning financial accounting and reporting standards.

Tax Fees: Consists of tax compliance/preparation and other tax services. Tax compliance/preparation consists of fees billed for professional services related to federal, state and international tax compliance. Other tax services consist of fees billed for other miscellaneous tax consulting and planning.

Pre-Approval Policies and Procedures for Audit and Non-Audit Services.

The Audit Committee has developed policies and procedures concerning its pre-approval of the performance of audit and non-audit services for the Company by Fitts, Roberts. These policies and procedures provide that the Chairman of the Audit Committee must pre-approve 100% of all audit and permitted non-audit services (including the fees and terms thereof). The Chairman reports all such services approved to the full Audit Committee at its next meeting. In pre-approving all audit services and permitted non-audit services, the Audit Committee or a delegated member must consider whether the provision of the permitted non-audit services is compatible with maintaining the independence of Fitts, Roberts and its status as the Company's independent auditors.

Table of Contents

Index to Financial Statements

SIGNATURES

In accordance with Section 13 or (15(d) of the Exchange Act, the Registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DATE: March 31, 2008

RELIABILITY INCORPORATED
(Registrant)

BY /s/ LARRY EDWARDS
Larry Edwards, Chairman of the Board of Directors,
President and Chief Executive Officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

DATE: March 31, 2008

BY /s/ LARRY EDWARDS
Larry Edwards, Chairman of the Board of Directors,
President and Chief Executive Officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the Company and in the capacities and on the dates indicated.

/s/ LARRY EDWARDS
Larry Edwards, Director

DATE: March 31, 2008

/s/ THOMAS L. LANGFORD
Thomas L. Langford, Director

DATE: March 31, 2008

/s/ PHILIP UHRHAN
Philip Uhrhan, Director

DATE: March 31, 2008

/s/ C. LEE COOKE JR.
C. Lee Cooke, Jr., Director

DATE: March 31, 2008

/s/ David Kurland
David Kurland, Director

DATE: March 31, 2008

Table of Contents

Index to Financial Statements

RELIABILITY INCORPORATED

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

| | Page |
|--|-------------|
| <u>Reports of independent registered public accounting firms</u> | F-2 |
| <u>Consolidated balance sheet at December 31, 2007</u> | F-3 |
| For each of the two years in the period ended December 31, 2007: | |
| <u>Consolidated statements of operations</u> | F-4 |
| <u>Consolidated statements of cash flows</u> | F-5 |
| <u>Consolidated statements of stockholders' equity</u> | F-6 |
| <u>Notes to consolidated financial statements</u> | F-7 |

F-1

Table of Contents

Index to Financial Statements

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders

Reliability Incorporated

We have audited the accompanying consolidated balance sheet of Reliability Incorporated as of December 31, 2007, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the two years in the period ended December 31, 2007. These financial statements are the responsibility of the Company's management. 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. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 Reliability Incorporated at December 31, 2007, and the consolidated results of its operations, changes in stockholders' equity and its cash flows for each of the two years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the financial statements, the Company's negative trends, including recurring losses from operations and negative cash flows from operating activities raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

We were not engaged to examine management's assertion about the effectiveness of Reliability Incorporated's internal control over financial reporting as of December 31, 2007, included as Item 8A in the accompanying 10KSB, and accordingly, we do not express an opinion thereon.

/s/ Fitts, Roberts & Co., P.C.

Houston, Texas
March 31, 2008

Table of Contents**Index to Financial Statements**

RELIABILITY INCORPORATED
CONSOLIDATED BALANCE SHEET
(In thousands, except share data)

| | December 31, 2007 |
|--|----------------------|
| ASSETS | |
| Current assets: | |
| Cash and cash equivalents | \$ 32 |
| Prepaid expenses | 33 |
| Assets of discontinued operations | 106 |
| Total current assets | 171 |
| Other assets: | |
| Assets held for sale | 225 |
| | \$ 396 |
| LIABILITIES AND STOCKHOLDERS EQUITY | |
| Current liabilities: | |
| Accounts payable and accrued liabilities | \$ 42 |
| Accrued liabilities of discontinued operations | 120 |
| Total current liabilities | 162 |
| Stockholders' equity: | |
| Common stock, without par value; 20,000,000 shares authorized; 6,690,265 shares issued | 9,767 |
| Accumulated deficit | (8,439) |
| Less treasury stock at cost, 354,300 shares | (1,094) |
| Total stockholders' equity | 234 |
| | \$ 396 |

See accompanying notes.

Table of Contents**Index to Financial Statements****RELIABILITY INCORPORATED****CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share data)**

| | Year ended December 31, | |
|---|-------------------------|----------|
| | 2007 | 2006 |
| Revenue | \$ | \$ |
| Costs and expenses: | | |
| Cost of goods sold | | |
| General and administrative | 483 | 1,301 |
| Impairment on real estate held for sale | 159 | |
| Total costs and expenses | 642 | 1,301 |
| (Gain) on sale of assets | (3) | (1,583) |
| Operating income (loss) from continuing operations | (639) | 282 |
| Other income (expense): | | |
| Interest (expense) | | (170) |
| Interest income | 19 | 53 |
| Other income | 4 | 39 |
| Total other income (expense) | 23 | (78) |
| Income (loss) from continuing operations, before income taxes | (616) | 204 |
| Provision for income taxes | | |
| Income (loss) from continuing operations | (616) | 204 |
| (Loss) from discontinued operations, net of income taxes | (1,377) | (382) |
| Net (loss) | \$ (1,993) | \$ (178) |
| Basic and diluted earning income (loss) per share: | | |
| Continuing operations | \$ (.10) | \$.03 |
| Discontinued operations | (.21) | (.06) |
| Net income (loss) | \$ (.31) | \$ (.03) |
| Weighted average shares: | | |
| Basic | 6,336 | 6,336 |
| Diluted | 6,336 | 6,336 |

See accompanying notes.

Table of Contents**Index to Financial Statements**

RELIABILITY INCORPORATED
CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

| | Year Ended December 31, | |
|--|-------------------------|----------|
| | 2007 | 2006 |
| Cash flows from operating activities: | | |
| Net income (loss) | \$ (1,993) | \$ (178) |
| Income (loss) from discontinued operations | (1,377) | (382) |
| Income (loss) from continuing operations | (616) | 204 |
| Adjustments to reconcile net income (loss) to cash used by operating activities: | | |
| Depreciation and amortization | 2 | 4 |
| Stock option expense | | 46 |
| Impairment loss on real estate | 159 | |
| (Gain) on sale of assets | (3) | (1583) |
| Provision for inventory obsolescence | | (9) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (2) | 215 |
| Prepaid expenses | 3 | 114 |
| Inventories | | 17 |
| Accounts payable and accrued liabilities | (104) | (287) |
| Total adjustments | 55 | (1,483) |
| Net cash (used) by continuing operations | (561) | (1,279) |
| Net cash (used) by discontinued operations | (176) | (263) |
| Net cash (used) by operating activities | (385) | (1,544) |
| Cash flows from investing activities: | | |
| Capital expenditures | (1) | |
| Proceeds from sale of investment securities | | 208 |
| Proceeds from sale of assets | | 4,108 |
| Proceeds from sale of discontinued operation | | 300 |
| Acquisition of business (net of cash acquired) | (787) | |
| Net cash (used) by investing activities | (788) | 4,616 |
| Cash flows from financing activities: | | |
| Increase in short-term debt | | 330 |
| Repayments of short-term debt | (53) | (2,886) |
| Net cash (used) provided by financing activities | (53) | (2,556) |
| Net increase (decrease) in cash | (1,226) | 516 |
| Cash and cash equivalents: | | |
| Beginning of period | 1,258 | 742 |
| End of period | \$ 32 | \$ 1,258 |

Edgar Filing: RELIABILITY INC - Form 10KSB

Supplemental cash flow information:

| | | | |
|--------------------------------------|----|-------|-----|
| Interest paid | | \$ | 170 |
| Owner financing of acquisition costs | \$ | 2,635 | |

F-5

Table of ContentsIndex to Financial Statements

RELIABILITY INCORPORATED
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY
AND ACCUMULATED OTHER COPREHENSIVE INCOME

(In thousands)

| | Common Stock | | | Treasury Stock (At Cost) | | Retained Earnings (Deficit) | Accumulated Other Comprehensive Income (Loss) | Total Amount |
|---|--------------|----------|----------------------------------|-----------------------------|------------|-----------------------------------|---|-----------------|
| | Shares | Amount | Additional Paid-in Capital | Shares | Amount | | | |
| Balance at December 31, 2005 | 6,690 | \$ 9,449 | \$ 272 | (354) | \$ (1,094) | \$ (6,268) | \$ 58 | \$ 2,417 |
| Comprehensive (loss): | | | | | | | | |
| Net (loss) | | | | | | (178) | | (178) |
| Issuance of options to purchase common stock under employee plans | | | 46 | | | | | 46 |
| Unrealized net gain on marketable equity securities | | | | | | | (58) | (58) |
| Balance at December 31, 2006 | 6,690 | \$ 9,449 | \$ 318 | (354) | \$ (1,094) | \$ (6,446) | \$ | \$ 2,227 |
| Net (loss) | | | | | | (1,993) | | (1,993) |
| Balance at December 31, 2007 | 6,690 | \$ 9,449 | \$ 318 | (354) | \$ (1,094) | \$ (8,439) | \$ | \$ 234 |

See accompanying notes.

F-6

Table of Contents

Index to Financial Statements

RELIABILITY INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2007

1. DISCONTINUANCE OF ALL OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Discontinuance of all Operations and Liquidity

During the past seven years, Reliability Incorporated and its subsidiaries (collectively referred to as *Reliability* or the *Company*) has sustained significant negative financial results, including substantial decreases in revenues, net income, backlog, and cash flows from operating activities that are generally attributable to operating losses. Due to the deterioration in its financial position, the Company has undergone significant restructuring to reduce its expenses and improve its liquidity, including: the closure of its Power Sources Costa Rica facility, significant downsizing of its domestic and international workforce, the sale of its Power Sources division, the closure of its Services division in Singapore, eliminated all research and development for test equipment, and the sale of its Houston headquarters facility. As a result of these actions, the Company significantly reduced its expenses. However, based upon its current financial position, and an evaluation of the prospects for continuing to operate its historical business lines, the Company concluded that it should explore other possibilities.

On April 1, 2007, Reliability completed the merger of its wholly owned subsidiary, Reliability-Medallion, Inc., a Florida corporation, into Medallion Electric Acquisition Corporation and the indirect acquisition, through Medallion Electric Acquisition Corporation, of Medallion Electric, Inc. Medallion Electric Acquisition Corporation was incorporated under the laws of the State of Florida on December 8, 2006 to facilitate a merger between business entities and was considered to be a development stage company with no operations at March 31, 2007. On June 21, 2007, the Company changed the name of Medallion Electric Acquisition Corporation (*MEAC*) to Reliability Contractors of Florida, Inc. Reliability Contractors of Florida, Inc. is a wholly-owned subsidiary of Reliability.

Medallion Electric, Inc. (*Medallion Electric* or *Medallion*) was incorporated in the State of Florida in 1980. Medallion Electric is an electrical contracting company, located in Coral Springs, Florida, specializing in electrical contracting services to residential homebuilders, with its major assets consisting of contracts for services to be performed and accounts receivable. Medallion Electric is a wholly-owned subsidiary of Reliability Contractors of Florida, Inc. (collectively referred to as *Reliability Florida* or *Electrical Contracting Services*).

All of the funds used for the initial acquisition payment and the Company's transaction costs related to the merger and acquisition were paid out of the Company's cash on hand. The Company funded \$750,000 to finance the acquisition. \$100,000 of such funds was made available to Medallion Electric as working capital; \$150,000 was used by MEAC to pay its transaction related expenses. The remaining \$500,000 was used to make the initial payment to the sole shareholder of Medallion Electric for 100% of the stock of Medallion Electric. The remainder of the purchase price consisted of two notes- one for \$500,000 due in six months and one for \$1.4 million due in six months. The Company secured the \$500,000 note with the pledge of its real property in North Carolina; the \$1.4 million note was secured with the assets of Medallion Electric.

The Company planned to pay the notes from the Company's working capital, funds generated by Electrical Contracting Services, additional debt and/or equity financing, and the sale of a part of its real estate located in North Carolina. However, in early September, 2007 it became apparent, the Company was not generating enough funds and had not been successful in raising debt or equity funds to meet all of the obligations which would be due on October 1, 2007. Therefore, the Reliability Board of Directors passed a resolution on September 25, 2007 that instructed management to enter into an agreement to sell Medallion Electric, Inc. back to the previous owner.

Table of Contents

Index to Financial Statements

RELIABILITY INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2007

On October 12, 2007, the Company and its subsidiaries Reliability Contractors of Florida, Inc. and Medallion Electric, Inc. entered into a Settlement, Sale of Stock and Release Agreement (*Agreement*) with Mr. Ronald Masaracchio, the previous owner, pursuant to which Reliability Contractors sold back the stock of Medallion effective October 1, 2007. The Company agreed to pay \$325,000 upon the closing of the sale of part of the Company's North Carolina real estate, which was under a purchase and sale contract, and transfer 100% of the Medallion stock to the previous owner, who agreed to release all the liens against the Company's assets, cancel all the notes, and release the Company from any and all of its obligations to him. In addition to the \$325,000, Reliability transferred all the stock of Medallion which held assets that were valued at approximately \$1.7 million on Reliability's balance sheet and liabilities which were generated in the normal course of business at Medallion valued at approximately \$529,000.

Upon the closing of the sale of a portion of Reliability's North Carolina real estate on October 26, 2007, the previous owner received the \$325,000, and the sale of Medallion Electric, the release of the liens, and cancellation of all the obligations was consummated. At the time of the sale, the previous owner held two notes totaling \$1.9 million, which were due October 1, 2007, and an earnout agreement which called for a minimum payment of \$750,000 over three years. The notes were secured by the assets of Medallion and the North Carolina property owned by Reliability. The sale of Medallion back to previous owner included a release of all liability on the notes and the earnout agreement, assumption of all Medallion ordinary course of business debts and obligations, mutual releases between Reliability and previous owner, including a release of the security for the notes. The net proceeds from the sale of a part of the North Carolina real estate to Reliability, after the \$325,000 payment and all other expenses of the sale, were \$292,000. The Company retained the ownership of 10 acres of land in North Carolina.

The accompanying financial statements have been prepared assuming the Company will continue as a going concern. However, upon the completion of the sale of Medallion Electric, the Company has no further operating activities. The Company has concluded that it should pursue one, or some combination, of the following courses of action: sell its remaining real estate holdings; invest in another line of business through a purchase or merger; make distributions to its shareholders from the proceeds of some of the assets, possibly through a dividend or 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.

The accompanying financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classifications of liabilities that may result from the possible inability of the Company to continue as a going concern.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for financial information and with instructions to Form 10-KSB. The consolidated financial statements include the financial transactions and accounts of the Company and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

The Company's business segments, Power Sources, Services, Testing Products, and Electrical Contracting Services are reported as discontinued operations in the accompanying Balance Sheet and Statement of Operations for each period presented. Certain income and expenses on the consolidated statement of operations and statement of cash flows for the periods ended December 31, 2006, related to these discontinued operations, have been reclassified to be consistent with the classifications adopted for the periods ended December 31, 2007. These reclassifications had no effect on net income.

Table of Contents

Index to Financial Statements

RELIABILITY INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2007

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.

Cash Equivalents

For the purposes of the statements of cash flows, the Company considers all highly liquid cash investments that mature in three months or less when purchased, to be cash equivalents. Cash equivalents are stated at cost, which approximates fair value.

Stock Options

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.

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 uncertainty. The Company records no tax benefits on its operating losses, as the losses will have to be carried forward and realization of any benefit is uncertain.

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (*FASB*) issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact, if any, that SFAS No. 157 will have on its results of operations and financial position.

In September 2006, the SEC issued Staff Accounting Bulletin (*SAB*) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*. SAB No. 108 provides guidance on the consideration of effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. SAB No. 108 requires the analysis of misstatements using both a balance sheet and income statement approach and contains guidance on correcting errors under the dual approach, as well as providing transition guidance for correcting errors existing in prior years. SAB No. 108 is effective for the first fiscal year ending after November 15, 2006. The adoption of SAB No. 108 did not have a material impact on the Company's results of operations or financial position.

Table of Contents**Index to Financial Statements****RELIABILITY INCORPORATED****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2007**

In June 2006, the FASB issued FASB Interpretation (*FIN*) No. 48, *Accounting for Uncertainty in Income Taxes*. FIN No. 48 is an interpretation of SFAS No. 109 and was adopted by the Company effective January 1, 2007. FIN No. 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements uncertain tax positions that the Company has taken or expects to take in the Company's tax returns. FIN No. 48 did not have a significant impact on the Company's financial statements.

2. ACQUISITION OF BUSINESS, GOODWILL AND SUBSEQUENT DISPOSAL OF ACQUIRED BUSINESSES**Acquisition**

On April 1, 2007, the Company consummated the merger of its wholly owned subsidiary, Reliability-Medallion, Inc., a Florida corporation, into Medallion Electric Acquisition Corporation, a Florida corporation (*MEAC*), and the indirect acquisition, through MEAC, of Medallion Electric, Inc., a Florida corporation (*Medallion Electric*). Medallion Electric is an electrical contracting company for homebuilders in Florida, with its major assets consisting of contracts for services to be performed and accounts receivable.

MEAC was a privately held company owned by eight shareholders unrelated to the Company. One shareholder unrelated to the Company or MEAC or any of MEAC's shareholders owned Medallion Electric.

The Company funded \$750,000 to MEAC after the Merger. \$100,000 of such funds was made available to Medallion Electric as working capital; \$150,000 was used by MEAC to pay its transaction related expenses. MEAC used the remaining \$500,000 to make the initial payment to the shareholder of Medallion Electric for his stock of Medallion Electric and delivered two notes for the remainder of the purchase price - one for \$500,000 due in six months and one for \$1,414,795 due in six months. The Company secured the \$500,000 note with the pledge of its real property in North Carolina; the \$1,414,795 note is secured with the assets of Medallion Electric.

Goodwill was recorded as the excess of the acquisition cost over the fair value of acquired net assets. The Medallion Electric acquisition cost is as follows (in thousands):

| | |
|-------------------------------------|-----------------|
| Cash payment to Medallion Electric | \$ 500 |
| Promissory notes payable | 1,915 |
| Guaranteed earnout over three years | 750 |
| Professional fees and expenses | 329 |
| | \$ 3,494 |

The fair value of the assets acquired and liabilities assumed at the date of acquisition is as follows (in thousands):

| | |
|------------------------|-------|
| Cash | \$ 72 |
| Other current assets | 1,340 |
| Property and equipment | 122 |
| Other assets | 5 |

Edgar Filing: RELIABILITY INC - Form 10KSB

| | |
|---------------------------|----------|
| Total assets acquired | 1,539 |
| Current liabilities | 218 |
| Long-term debt | 19 |
| Total liabilities assumed | 237 |
| Net assets acquired | \$ 1,302 |

F-10

Table of Contents**Index to Financial Statements****RELIABILITY INCORPORATED****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2007**

The excess of the cost over the fair value of acquired net assets resulted in goodwill, as follows (in thousands):

| | |
|--------------------------|-----------------|
| Purchase price | \$ 3,494 |
| Less net assets acquired | (1,302) |
| Goodwill | \$ 2,192 |

Disposition

The Company passed a resolution on September 25, 2007 to sell Medallion Electric back to its previous owners and the operation was sold effective October 1, 2007, as discussed in Note 1. Medallion Electric is included as a discontinued operations as disclosed in Note 3.

3. 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 maintained a small number of employees to complete unfinished jobs, provide limited services for its customers while they seek alternative service providers, prepare equipment for sale and vacate the division's leased facility. The liquidation of the Company's former Services division was substantially complete as of June 30, 2007.

In April of 2007, following the acquisition of Medallion Electric, the Company concluded that it should abandon its Testing Products business in favor of concentrating all available resources on its newly acquired business line, Electrical Contracting Services.

On September 25, 2007, the Company's Board of Directors passed a resolution to sell Medallion Electric to the previous owner. Therefore, the Electrical Contracting Services (Medallion Electric) is included as a discontinued operation.

The loss from the discontinued Electrical Contracting Services includes the loss on the disposition of the Electrical Contracting Service (Sale of Medallion Electric) as follows:

| | |
|--|-------------------|
| Electrical Contracting Services: (in thousands) | |
| Assets sold | \$ (3,882) |
| Liabilities extinguished | 3,168 |
| Costs of sale of business | (325) |
| Loss on Disposition | \$ (1,039) |

Table of Contents**Index to Financial Statements****RELIABILITY INCORPORATED****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2007**

The loss from the operations of the Electrical Contracting Services is included in the table below.

Results of operations for the Company's former Power Sources, Services, Testing Products, and Electrical Contracting Services segments 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):

| | 2007 | 2006 |
|---|------------|----------|
| Revenues: | | |
| Power Sources | | 131 |
| Services | 36 | 520 |
| Testing Products | 6 | 230 |
| Electrical Contracting Services | 1,956 | |
| | \$ 1,998 | \$ 881 |
| Income (loss) from discontinued operations: | | |
| Power Sources | | 59 |
| Services | (131) | (650) |
| Testing Products | 4 | 35 |
| Electrical Contracting Services | (1,250) | |
| | \$ (1,377) | \$ (556) |

The assets and liabilities of the Company's former Services segment are reported as assets of discontinued operations and accrued liabilities of discontinued operations in the accompanying Consolidated Balance Sheet for each period presented. There are no remaining assets or liabilities of the Company's former Power Sources or Testing Products segment. The assets and accrued liabilities from discontinued operations of the Company's former Services segment are as follows (in thousands):

| | December 31, 2007 |
|--|----------------------|
| Assets: | |
| Cash | \$ 91 |
| Accounts receivable | 15 |
| | \$ 106 |
| Accrued liabilities: | |
| Accrued payroll and termination benefits | \$ 113 |
| Other accrued liabilities | 7 |

F-12

Table of ContentsIndex to Financial Statements

RELIABILITY INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2007

4. ASSETS HELD FOR SALE AND IMPAIRMENT LOSS

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

| | |
|--|--------|
| Land 10 Acres North Carolina- Assets held for sale Long Term Portion | \$ 225 |
|--|--------|

The Company shut down a Services facility in North Carolina in April 1998. On October 26, 2007, seven and one half acres of the land and a building previously occupied by the Services operation were sold for \$675,000 cash. The Company still retains 10 acres of land adjacent to the property that was sold. The previous owner of Medallion Electric held a lien on the property in the form of a note. \$325,000 of the proceeds were paid and the lien has been released. The value of the land is presented as assets held for sale in the accompanying consolidated balance sheet. An impairment loss of \$159,000 was recorded in the third quarter of 2007 to reduce the carrying value of the real estate held for sale. The property has been actively marketed since 1998, although no assurances can be given the remaining acreage will be sold during 2008.

5. INCOME TAXES

The components of income (loss) before income taxes from continuing operations are as follows (in thousands):

| | 2007 | 2006 |
|--|----------------|--------|
| | (In thousands) | |
| Income (loss) from continuing operations | \$ (616) | \$ 204 |

The components of income tax expense (benefit) consists of the following (in thousands):

| | 2007 | 2006 |
|-----------------------|------|------|
| Federal income taxes: | | |
| Current | \$ | \$ |
| Deferred | | |
| State income taxes: | | |
| Current | | |
| Deferred | | |
| Foreign income taxes: | | |
| Current | | |
| Deferred | | |
| | \$ | \$ |

Table of ContentsIndex to Financial Statements

RELIABILITY INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2007

The Company's effective tax rate differs from the U. S. federal statutory rate of 34% as follows:

| | 2007 | 2006 |
|--|----------------|-------|
| | (In thousands) | |
| Income tax expense (benefit) at the U. S. federal statutory rate | \$ (209) | \$ 69 |
| Change in valuation allowance | 209 | (71) |
| Other | | 2 |
| | \$ | \$ |

The significant components of the Company's net deferred tax assets (liabilities) at December 31, 2007 were as follows (in thousands):

| | 2007 |
|------------------------------|-------|
| Deferred tax assets: | |
| Impairment reserves | \$ 54 |
| Net operating loss carryover | 5,308 |
| Capital loss carryover | 199 |
| Total deferred tax assets | 5,561 |
| Valuation allowance | 5,561 |
| Net deferred tax assets | \$ 0 |

The Company has established valuation allowances related to certain tax benefits where management believes that the available evidence indicates that it is more likely than not that the Company will not realize the tax benefit. The Company intends to maintain a full valuation allowance until sufficient positive evidence exists to support reversal of the valuation allowance.

At December 31, 2007, the Company had U.S. net operating loss carryforwards of \$15.3 million that will expire commencing in 2023 through 2027. These carryforwards may be subject to certain limitations on annual utilization in the event of a change in ownership, as defined by tax law.

The Company made no cash payments for income taxes in 2007 or 2006.

Table of ContentsIndex to Financial Statements**RELIABILITY INCORPORATED****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2007****6. ACCRUED LIABILITIES**

Accrued liabilities as of December 31, 2007 consists of the following (in thousands):

| | |
|-------------------|--------------|
| Property taxes | \$ 5 |
| Professional fees | 16 |
| Insurance | 19 |
| Other | 2 |
| | \$ 42 |

7. EMPLOYEE STOCK SAVINGS PLAN

The Reliability Incorporated Employee Stock Saving Plan (the "Plan") (As Amended and Restated Effective January 1, 2000) was terminated effective November 16, 2006, with all accounts fully vested as of such date. The Company filed the termination of the Plan with the Internal Revenue Service to request a favorable letter of determination and notified all employees covered by the Plan of its termination, and their rights to final payment thereunder.

The Plan allowed eligible United States employees to contribute up to 100% of defined compensation to the Plan and to elect to have contributions not be subject to Federal income taxes under Section 401(k) of the Internal Revenue Code. The Company matched employee contributions to the Plan at a rate equal to 50% of the employee's contribution, but the Company's matching contribution was limited to 2% of the employee's defined compensation. The Company also made a voluntary contribution of an amount equal to 1% of the defined compensation of all participants. The Company also contributed a profit sharing amount based on the consolidated profits of the Company. The maximum profit sharing contribution was 5% of compensation. The Company's contributions for matching and voluntary contributions (there were no profit sharing contributions in 2007 or 2006) were \$0 in 2007 and \$7,500 in 2006.

The Company registered and reserved 500,000 shares in 1992, and registered and reserved 500,000 additional shares in 2001, of common stock for sale to the Plan. The registration statements cover shares purchased both in the open market and from the Company. The Plan did not purchase any shares from the Company during the two-year period ending in 2007. At December 31, 2006, 354,300 reserved shares remain unissued under the 2001 registration statement. There are no plans to issue the reserved shares as the plan has been terminated.

Table of ContentsIndex to Financial Statements

RELIABILITY INCORPORATED

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

December 31, 2007

8. STOCK OPTION PLAN

On 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. 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.

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.

Under the Company's Amended and Restated 1997 Stock Option Plan (the *Plan*), no further option grants are allowed after February 26, 2007, but options theretofore granted shall remain in effect until satisfied or terminated pursuant to the Plan. No options were granted under the Plan during the year ended December 31, 2007.

At December 31, 2006, all options were fully vested. During 2007 no new options were granted, thus, no further stock option expense will be recorded related to the Plan. All outstanding options were out-of-the money as of December 31, 2007, resulting in an aggregate intrinsic value of nil. The weighted-average remaining contractual term, as of December 31, 2007, was 8.80 years for outstanding and exercisable options. The following table summarizes option activity for the year ended December 31, 2007:

| | Number of Options | Weighted Average Price |
|-------------------------------------|----------------------|------------------------------|
| Balance as of December 31, 2006 | 951,851 | \$ 1.67 |
| Expired or canceled | (581,851) | 2.60 |
| Exercised | | |
| Granted | | |
| Balance as of December 31, 2007 | 370,000 | \$.21 |
| Exercisable as of December 31, 2007 | 370,000 | \$.21 |

In addition to the options outstanding under the Company's Stock Option Plan, 100,000 options issued in connection with a business combination were outstanding and exercisable at December 31, 2007. These options are exercisable at \$1.50 per share and expire in July 2009.

Table of Contents

Index to Financial Statements

RELIABILITY INCORPORATED

INDEX TO EXHIBITS

| Exhibit Number | Description |
|---------------------------|--|
| 21 | List of Subsidiaries. |
| 23 | Consent of Independent Registered Public Accounting Firm. |
| 31.1 | Certifications Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act |
| 32 | Certifications Pursuant to Rule 13a-14(b)/15d-14(b) and Section 1350, Chapter 63, Title 18 of the United States Code |