UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-QSB

x **QUARTERLY REPORT UNDER SECTION 13 or 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2005

¨ **TRANSITION REPORT UNDER SECTION 13 or 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________.

Commission File Number 0-7092

RELIABILITY INCORPORATED

(Name of small business issuer in its charter)

TEXAS **(State or other jurisdiction of incorporation or organization)**	**75-0868913** **(I.R.S. Employer Identification Number)**
16400 Park Row **Post Office Box 218370** **Houston, Texas** **(Address of principal executive offices)**	**77218-8370** **(Zip Code)**

(281) 492-0550

(Issuer s telephone number, including area code)

Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past twelve months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past ninety days.   YES x   NO ¨

State the number of shares outstanding of each of the issuer s classes of common equity, as of the latest practicable date: 6,335,965 shares of Common Stock, no par value as of November 7, 2005.

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

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

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

RELIABILITY INCORPORATED

UNAUDITED CONSOLIDATED BALANCE SHEET

(In thousands)

	September 30, 2005
ASSETS	
Current assets:	
Cash and cash equivalents	$ 617
Accounts receivable	490
Inventories	304
Prepaid expenses	128
Assets held for sale	2,488
Total current assets	4,027
Property, plant and equipment, at cost:	
Machinery and equipment	11,810
Leasehold Improvements	622
	12,432
Less accumulated depreciation	12,226
	206
Investments	205
Assets held for sale	1,000
	$ 5,438
LIABILITIES AND STOCKHOLDERS EQUITY	
Current liabilities:	
Accounts payable	72
Accrued liabilities	594
Notes payable	1,866
Total current liabilities	2,532
Stockholders equity:	
Common stock, without par value; 20,000,000 shares authorized; 6,690,265 shares issued	9,721

Accumulated deficit		(5,776)
Accumulated other comprehensive income (loss)		55
Less treasury stock at cost, 354,300 shares		(1,094)
Total stockholders equity		2,906
	$	5,438

See accompanying notes.

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RELIABILITY INCORPORATED

UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	Nine Months Ended September 30,	
	2005	**2004**
Revenues		
Product sales	$ 1,010	$ 1,217
Services	1,128	1,228
	2,138	2,445
Costs and expenses:		
Cost of product sales	1,185	1,085
Cost of services	1,052	1,340
Marketing, general and administrative	1,975	2,275
Research and development	653	497
Severance costs	156	
	5,021	5,197
Operating loss	(2,883)	(2,752)
Interest expense	151	
Interest income	12	17
Other income - net	23	37
Loss from continuing operations	(2,999)	(2,698)
Income (loss) from discontinued operations	7	(1,181)
Net loss	$ (2,992)	$ (3,879)
Basic and diluted loss per share:		
Continuing operations	$ (.47)	$ (.42)
Discontinued operations		(.19)
Net loss	$ (.47)	$ (.61)
Weighted average shares:		
Basic	6,336	6,336
Diluted	6,336	6,336

See accompanying notes.

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UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except share data)

	Three Months Ended September 30,	
	2005	2004
Revenues:		
Product sales	$ 329	$ 446
Services	432	475
	761	921
Costs and expenses:		
Cost of product sales	293	399
Cost of services	346	430
Marketing, general and administrative	584	776
Research and development	80	166
Severance costs	156	
	1,459	1,771
Operating loss	(698)	(850)
Interest expense	65	
Interest income	4	6
Other income (expense) - net	14	12
Loss from continuing operations	(745)	(832)
Income (loss) from discontinued operations	28	(830)
Net loss	$ (717)	$ (1,662)
Basic and diluted income (loss) per share:		
Continuing operations	$ (.12)	$ (.13)
Discontinued operations	.01	(.13)
Net loss	$ (.11)	$ (.26)
Weighted average shares:		
Basic	6,336	6,336
Diluted	6,336	6,336

See accompanying notes.

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UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Nine Months Ended September 30,	
	2005	2004
Cash flows from operating activities:		
Net loss	$ (2,992)	$ (3,879)
Adjustments to reconcile net loss to cash used by operating activities:		
Depreciation and amortization	381	621
Provision for inventory obsolescence	185	91
Asset impairment charges	81	673
Provision for uncollectible accounts	2	
Write off leasehold improvements	17	
Write down equity investments	37	
Gain on sale of equipment	(40)	
Changes in operating assets and liabilities:		
Accounts receivable	192	(288)
Inventories	58	13
Prepaid expenses and other current assets	86	(43)
Accounts payable	(27)	(249)
Accrued liabilities	88	225
Other current assets	3	
Total adjustments	1,063	1,043
Net cash used by operating activities	(1,929)	(2,836)
Cash flows from investing activities:		
Acquisition of Ezy-Load product line		(75)
Proceeds from sale of equipment	65	
Expenditures for property and equipment	(2)	(9)
Net cash provided (used) by investing activities	63	(84)
Cash flows from financing activities:		
Borrowings under line of credit	1,025	
Repayments on line of credit	(150)	
Principal payments on notes payable	(9)	
Net cash provided (used) by financing activities	866	
Net decrease in cash	(1,000)	(2,920)
Cash and cash equivalents:		
Beginning of period	1,617	4,454

End of period	$ 617	$ 1,534
Supplemental cash flow information:		
Interest paid	$ 95	

See accompanying notes.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2005

1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with instructions to Form 10-QSB and Item 10 of Regulation S-B. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the interim period ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

The consolidated financial statements include the financial transactions and accounts of the Company and its wholly-owned subsidiary. All significant intercompany balances and transactions have been eliminated in consolidation. For further information, refer to the financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2004.

Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires that management make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

Income Taxes

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

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Inventories

Inventories are stated at the lower of standard cost (which approximates first-in, first-out) or market (replacement cost or net realizable value) and include (in thousands):

	September 30, 2005
Raw materials	$ 151
Work-in-progress	38
Finished goods	115
	$ 304

Inventories are presented net of reserves for excess and obsolete inventories of $706,000.

Investments in Marketable Equity and Debt Securities

All investments are classified as held to maturity or available-for-sale securities under the provisions of Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities. Management determines the appropriate classification of its investments in equity and debt securities at the time of purchase and reevaluates such determinations at each balance sheet date.

Marketable equity securities are classified as available-for-sale and are carried at their fair value on the balance sheet, with unrealized gains and losses reported as a separate component of stockholders equity. Marketable equity securities are stated at market value, as determined by the most recently published trade price of the securities at the balance sheet date.

During the quarter ended June 30, 2005, the Company recorded a charge of $37,000 to reflect a decline in the fair value of securities that was deemed to be other-than-temporary.

The following table summarizes the Company s investment in securities (in thousands) at Sept. 30, 2005:

Marketable equity securities, at cost	$ 150
Unrealized net gains (losses) on marketable securities	55
	$ 205
Amount classified as current	
Amount classified as long-term	$ 205

Earnings per Share

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

Reclassifications

Certain reclassifications have been made in prior years financial statements to conform to classifications used in the current year.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

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Stock Options

The Company has a stock option plan that provides for the grant of options to key employees and directors of the Company. The term and vesting of each option is determined by the Board of Directors. The Company accounts for stock options using the intrinsic value based method prescribed by APB 25. Had the Company elected to account for stock options using the fair value method described in SFAS No. 123, the Company s reported net loss would have increased to the amounts shown below (in thousands, except share data):

	Nine months ended September 30		Three months ended September 30	
	2005	**2004**	**2005**	**2004**
Reported net loss	$ (2,992)	$ (3,879)	$ (717)	$ (1,662)
Deduct: Total stock-based employee compensation expense determined under the fair value method for all awards, net of related tax effects	(43)	(103)	(3)	(22)
Pro forma net loss	$ (3,035)	$ (3,982)	$ (720)	$ (1,684)
Basic and Diluted loss per share, as reported:				
Continuing operations	$ (.47)	$ (.42)	$ (.12)	$ (.13)
Discontinued operations		(.19)	.01	(.13)
Net Loss	$ (.47)	$ (.61)	$ (.11)	$ (.26)
Pro forma net loss per share, as if the fair value method had been applied to all awards:				
Continuing operations	$ (.48)	$ (.44)	$ (.12)	$ (.14)
Discontinued operations		(.19)	.01	(.13)
Net Loss	$ (.48)	$ (.63)	$ (.11)	$ (.27)

The pro forma disclosures above are not necessarily indicative of the effects of applying SFAS 123 in future periods.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2005

2. LIQUIDITY

The Company s business is largely dependent on the capital equipment expenditures of integrated circuit manufacturers and the overall demand for products utilizing integrated circuits. Beginning in 2001, the entire semiconductor industry experienced a sharp downturn that resulted in a significant decrease in demand for the Company s products and services. As a result, revenues in the three-year period from 2002 through 2004 of $9.3 million were less than 2001 revenues of $12.1 million. Other factors contributing to this decline include overcapacity in the markets the Company serves, increased competition from foreign sources, reduced capital spending, significant reductions in burn-in times by some customers, a move away from conventional burn-in by a major customer, and the Company s inability to generate sales for its newer products and services.

During the period from 2002-2004, the Company made several workforce reductions and restructured its operations in order to reduce its fixed operating costs. Despite these cost reduction actions, the Company incurred operating losses of $21.5 million, pre-tax losses of $20.4 million and consumed approximately $15.4 million of its cash reserves during this period. As a result of these continuing operating losses and decline in the Company s cash position, substantial doubt is raised about the Company s ability to continue as a going concern.

In order to generate funds for continued operations, the Company is attempting to sell its Houston headquarters building. As an interim step, to allow for an orderly sale of the building, the Company obtained bridge financing in December 2004 from an asset-based lender. The financing facility will provide up to $2.9 million of liquidity, has an initial term of eighteen months, and may be renewed for an additional twelve-month period, subject to certain terms and conditions. At September 30, 2005, the Company had $1 million of remaining availability under this facility. Upon the sale of the Houston building, the Company must first repay the bridge loan, and any excess funds can be used to fund the Company s operations. The Company is also attempting to sell an idle manufacturing facility in North Carolina. All proceeds from the sale of this facility can be used to fund the Company s operations, since this facility is not pledged as collateral under the financing facility.

At its present cash burn rate, in mid-2006 the Company will exhaust its cash resources and have no remaining availability under its debt agreement. In order to continue operations beyond that point, the Company must generate cash proceeds from asset sales, the sale of a business line, the issuance of additional debt or equity instruments, or enter into a business combination. There can be no assurances that the Company can consummate any such transactions, or that the proceeds from such transactions will be sufficient to enable the Company to continue operations through the end of 2006. For further information, refer to the financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2004 and Note 8 to this Form 10-QSB.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

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3. SEGMENT INFORMATION

The following table presents reportable segment information (in thousands) for the periods indicated:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2005	**2004**	**2005**	**2004**
Revenues from external customers:				
Testing Products	$ 491	$ 504	$ 187	$ 194
Services	1,127	1,228	432	475
Power Sources	520	713	142	252
Intersegment revenues:				
Testing Products	16	56	6	23
Services	6	4		
Power Sources				
Eliminations	(22)	(60)	(6)	(23)
	$ 2,138	$ 2,445	$ 761	$ 921
Operating loss:				
Testing Products	$ (1,757)	$ (1,359)	$ (350)	$ (404)
Services	(393)	(594)	(60)	(86)
Power Sources	(442)	(145)	(143)	(71)
General corporate expenses	(291)	(654)	(145)	(289)
Operating loss	$ (2,883)	$ (2,752)	$ (698)	$ (850)

Total assets by reportable segment as of the dates indicated are as follows (in thousands):

	September 30, 2005
Testing Products	$ 133

Services		975
Power Sources		305
General corporate assets		4,025
	$	5,438

To consistently present the allocation of corporate expenses to the operating divisions, an additional $90,000 and $270,000 of corporate overhead has been allocated to the Services segment for the three and nine-month periods ended September 30, 2004. This resulted in a corresponding decrease in general corporate expenses of like amounts in the respective periods.

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Other than as described above, there were no other changes in the accounting policies and procedures used to determine segment income or loss. It should also be noted that due to the closure of the Automotive segment in January 2005, corporate allocations to the remaining operating segments increased. In the 2004 period, $221,000 of corporate overhead was allocated to the Automotive segment.

In September 2005, the Company s headquarters building, with a net book value of $2.4 million, was reclassified to Assets Held for Sale in the accompanying balance sheet. As a result, the building, which has historically been reported in the Testing Products segment, is now being reported as a general corporate asset.

Sales to a major customer in the Services segment accounted for 38% and 41% of consolidated revenues in the nine month period ended September 30, 2005 and 2004, respectively. Loss of this major customer would have a material adverse affect on the company s results of operations and financial position.

4. COMPREHENSIVE LOSS

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

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2005	2004	2005	2004
Net (loss)	$ (2,992)	$ (3,879)	$ (717)	$ (1,662)
Unrealized net gains (losses) on marketable equity securities	5	(33)	22	(23)
Add: reclassification adjustment for losses included in net loss	37			
Total comprehensive (loss)	$ (2,950)	$ (3,912)	$ (695)	$ (1,685)

5. OTHER INCOME

Other income consists of the following:

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2005	2004	2005	2004
Rental income	$ 59	$ 37	$ 13	$ 12
Write-down of investment securities	(37)			
Gain on sale of assets	1		1	
	$ 23	$ 37	$ 14	$ 12

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2005

6. DISCONTINUED OPERATIONS AUTOMOTIVE DIVISION

Effective January 29, 2005, the Company terminated the Asset Purchase Agreement between the Company and Futura International, Inc. (Futura) for the purchase of the Ezy-Load product line. The Company elected to terminate the agreement due to continued disappointing sales of the product and the amount of capital required to sustain the sales and marketing efforts. As a result of the termination, the Company ceased manufacturing and marketing the Ezy-Load product. With the exception of inventories, the Company reconveyed to Futura all assets previously acquired from Futura, consisting primarily of intellectual property rights. The Company is relieved of all payment liabilities to Futura, including $225,000 of contingent purchase price payments scheduled for 2005 and future royalties.

Results of operations for the former Ezy-Load segment are reported as discontinued operations in the accompanying Statement of Operations for each period presented. Net sales and the results from discontinued operations are as follows (in thousands):

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2005	2004	2005	2004
Product Sales	$ 37	$ 39	$	$ 17
Income (loss) from discontinued operations	$ 7	$ (1,181)	$ 28	$ (830)

Income from discontinued operations for the three-month period ended September 30, 2005 resulted from the sale of inventories that had been written off.

7. IMPAIRMENT REVIEW

During January 2005, the Company placed a Criteria 20 unit with a semiconductor manufacturer to enable the customer to evaluate the performance of the unit. Late in June 2005, the semiconductor manufacturer notified the Company that it would be returning the unit to the Company and that it no longer had plans to purchase a unit.

In light of this negative development in terms of potential future sales for the Testing Products Division, it was determined that a review of the recoverability of the assets of the Division should be performed. As a result of this review, an impairment charge of $81,000 was recorded to reduce the carrying value of the fixed assets of the Division to their estimated fair value. Additionally, a charge of $87,000 was recorded to reduce the carrying value of the Division s inventory. These charges were recorded in June 2005 and are reported as Cost of Product Sales in the accompanying financial statements.

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NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

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8. REDUCTION IN WORKFORCE

Due to the continued lack of demand for the Company s burn-in and test systems, with no existing prospects for a sale of a Criteria 20 in the foreseeable future, and in order to reduce cash expenditures, the Company decided to suspend research and development activities and to reduce resources in related sales, production and testing functions in its Testing Products Division. Effective August 5, 2005, the Company reduced its Houston-based workforce by 45%. Severance costs of $156,000 were incurred are reported in the results of operations for the period ended September 30, 2005. The estimated annual savings of this workforce reduction are $650,000, of which $320,000 is estimated to be in research and development costs, $230,000 in cost of sales and $100,000 in marketing, general and administrative expenses.

9. ASSETS HELD FOR SALE

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

Land and building Houston	$ 2,437
Production equipment	51
Total current	2,488
Land and building North Carolina	1,000

As a result of the impairment review described in Note 7 above, the fair value of the non-current assets of the Testing Products Division was determined to be $51,000, representing the estimated value of production equipment. Whereas all of the employees of the production department were terminated as part of the reduction in workforce described in Note 8 above, the Company has placed this equipment for sale.

In 2003, the Company listed its Houston headquarters building for sale. In previous periods, it was determined that the building did not meet the criteria to be classified as held for sale , due to logistical requirements that might have required a potential sales contract to include terms that were not deemed to be usual and customary for the sales of such assets .

As a result of the cessation of research and development activities in the Testing Product Division (as discussed in Note 8) and the decision to sell the production equipment of the Division, it has been determined that the Houston headquarters building now meets the criteria to be classified as held for sale in the accompanying balance sheet.

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RELIABILITY INCORPORATED

MANAGEMENT S DISCUSSION AND ANALYSIS OR

PLAN OF OPERATIONS

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

FORWARD-LOOKING STATEMENTS

This Management s Discussion and Analysis or Plan of Operations and other parts of this report contain forward-looking statements that involve risks and uncertainties, as well as current expectations and assumptions. From time to time, the Company may publish forward-looking statements, including those that are contained in this report, relating to such matters as anticipated financial performance, business prospects, technological developments, new products, research and development activities and similar matters. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. In order to comply with the terms of the safe harbor, the Company notes that a variety of factors could cause the Company s actual results and experience to differ materially from the anticipated results or other expectations expressed in the Company s forward-looking statements. The risks and uncertainties that may affect the operations, performance, development and results of the Company s business include, but are not limited to, its ability maintain sufficient working capital, adverse changes in the global economy, sudden decreases in the demand for electronic products and semiconductors, market acceptance of the Company s products and services, the impact of competition, delays in product development schedules, delays due to technical difficulties related to developing and implementing technology, delays in delivery schedules, the ability to attract and maintain sufficient levels of people with specific technical talents, future results related to investments and acquisitions, changes in demand for the Company s products and services and the Company s customers products and services. The Company s actual results could differ materially from those anticipated in these forward-looking statements, including those set forth elsewhere in this report. The Company assumes no obligation to update any such forward-looking statements.

CRITICAL ACCOUNTING POLICIES AND COMMENTS RELATED TO OPERATIONS

The Company has defined a critical accounting policy as one that is both important to the portrayal of the Company s financial condition and results of operations and requires the management of the Company to make difficult, subjective or complex judgments. Estimates and assumptions about future events and their effects cannot be perceived with certainty. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments. These estimates may change as new events occur, as more experience is acquired, as additional information is obtained and as the Company s operating environment changes. There have been no material changes or developments in the Company s evaluation of the accounting estimates and the underlying assumptions or methodologies that it believes to be Critical Accounting Policies and Estimates as disclosed in its Form 10-K for the year ended December 31, 2004.

Management s Discussion included in the Form 10-K for the year ended December 31, 2004 includes discussion of various factors related to the decline in the Company s revenues and items related to the Company s results of operations, liquidity and markets. There have been no significant changes in most of the factors discussed in the Form 10-K and many of the items discussed in the Form 10-K are relevant to 2005 operations; thus the reader of this report should read Management s Discussion included in Form 10-K for the year ended December 31, 2004.

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RELIABILITY INCORPORATED

MANAGEMENT S DISCUSSION AND ANALYSIS OR

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September 30, 2005

LIQUIDITY AND CAPITAL RESOURCES

The Company s business is largely dependent on the capital equipment expenditures of integrated circuit manufacturers and the overall demand for products utilizing integrated circuits. Beginning in 2001, the entire semiconductor industry experienced a sharp downturn that resulted in a significant decrease in demand for the Company s products and services. As a result, revenues in the three-year period from 2002 through 2004 of $9.3 million were less than 2001 revenues of $12.1 million. Other factors contributing to this decline include overcapacity in the markets the Company serves, increased competition from foreign sources, reduced capital spending, significant reductions in burn-in times by some customers, a move away from conventional burn-in by a major customer, and the Company s inability to generate sales for its newer products and services.

During the period from 2002-2004, the Company made several workforce reductions and restructured its operations in order to reduce its fixed operating costs. Despite these cost reduction actions, the Company incurred operating losses of $21.5 million, pre-tax losses of $20.4 million and consumed approximately $15.4 million of its cash reserves during this period. As a result of these continuing operating losses and decline in the Company s cash position, substantial doubt is raised about the Company s ability to continue as a growing concern.

In order to generate funds for continued operations, the Company is attempting to sell its Houston headquarters building. As an interim step, to allow for an orderly sale of the building, the Company obtained bridge financing in December 2004 from an asset-based lender. The financing facility will provide up to $2.9 million of liquidity, has an initial term of eighteen months, and may be renewed for an additional twelve-month period, subject to certain terms and conditions. At September 30, 2005, the Company had $1 million of remaining availability under this facility. Upon the sale of the Houston building, the Company must first repay the bridge loan, and any excess funds can be used to fund the Company s operations. The Company is also attempting to sell an idle manufacturing facility in North Carolina. All proceeds from the sale of this facility can be used to fund the Company s operations, since this facility is not pledged as collateral under the financing facility. The Houston property has been on the market for over one year and the North Carolina property for in excess of five years.

At its present cash burn rate, in mid-2006 the Company will exhaust its cash resources and have no remaining availability under its debt agreement. In order to continue operations beyond that point, the Company must generate cash proceeds from asset sales, the sale of a business line, the issuance of additional debt or equity instruments, or enter into a business combination. There can be no assurances that the Company can consummate any such transactions, or that the proceeds from such transactions will be sufficient to enable the Company to continue operations through the end of 2006. See also Note 8 to the consolidated financial statements that discusses cash outflows associated with cost reduction measures taken in August 2005.

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September 30, 2005

Net cash used by operating activities for the nine months ended September 30, 2005 was $1,929,000, compared to $2,836,000 in the comparable 2004 period. The decrease in cash consumed by operations consists of $165,000 related to a lower net loss, net of non-cash items and $742,000 of changes in working capital accounts.

During the nine months ended September 30, 2005, investing activities generated $63,000 of cash through the sale of excess assets net of $2,000 in capital expenditures. In the prior year, investing activities consumed $84,000 of cash as a result of a $75,000 payment related to the Ezy-Load acquisition and $9,000 of capital expenditures.

Financing activities generated $866,000 of cash during the nine months ended September 30, 2005, as a result of borrowings of $1,025,000 and repayments of $159,000.

RESULTS OF OPERATIONS

Nine months ended September 30, 2005 compared to nine months ended September 30, 2004.

Revenues.

Revenues in the first nine months of 2005 were $2,138,000, compared to $2,445,000 in the first nine months of 2004. Revenues declined in each of the Company s three traditional business segments as follows: Testing Products (3)%, Services (8)% and Power Sources (27)%.

Revenues in the Testing Products segment decreased by $13,000 from the comparable 2004 period. An increase in system refurbishment/upgrade revenue of $92,000 was offset by a decrease in spare parts sales in Asian markets.

Revenues in the Services segment decreased by $101,000 from the 2004 period. Burn-in and test revenues decreased by $88,000 as a result of a 31% decrease in units processed, offset by a 34% increase in average selling prices due to changes in product mix and increased processing times. Additionally, sales of burn-in boards decreased by $13,000.

Revenues in the Power Sources segment decreased by $193,000, as a 31% decrease in units sold was partially offset by a 5% increase in average sales prices. The increase in average selling prices is due to a change in product mix, as sales in 2005 included more higher output devices.

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September 30, 2005

Gross Profit

Gross margin decreased from $20,000 for the nine months ended September 30, 2004 to ($99,000) in the 2005 period. Gross margin by industry segment for the periods is presented below (in thousands):

	Nine Months Ended September 30	
	2005	**2004**
Testing Products	$ (213)	$ (85)
Services	87	(112)
Power Sources	27	217
Total	$ (99)	$ 20

The decrease in margin in the Testing Products segment resulted primarily from $168,000 in impairment charges (see Note 8 to the Consolidated Financial Statements) and changes in product mix, offset by a $54,000 reduction in engineering charges for the modification of developed products. The engineering resources were devoted to research and development projects in 2005. The increase in the Services segment resulted primarily from a $161,000 decrease in depreciation, as many of the Division s assets are reaching the end of their assigned depreciable lives, a decrease in repairs and maintenance charges of $133,000, resulting from charges incurred in the prior year for the repair of test equipment and costs associated with relocating equipment from leased space that was vacated, offset by a $30,000 increase in rent allocated to production departments and the impact of the $101,000 decrease in revenues. The decrease in margin in the Power Sources segment is attributable to lower sales volume and production activity, $20,000 in re-work costs for a job for which the Company received a sub-assembly that was not in accordance with specifications and a quantity discount allowed for the order and $38,000 of charges for slow-moving and potentially obsolete inventory.

Marketing, General and Administrative

Marketing, general and administrative expenses decreased from $2,275,000; on the first nine months of 2004 to $1,975,000 in the first nine months of 2005. Of this decrease, $73,000 is attributable to engineering charges supporting specific sales efforts, $80,000 is due to lower corporate compliance costs and professional fees, $52,000 is due to lower amortization charges for demonstration equipment, $53,000 relates to lower headcount, $18,000 is attributable to lower liability and casualty insurance expense and $17,000 is due to lower property tax expense.

Research and Development

Research and development costs were $653,000 in the first nine months of 2005, compared to $497,000 in the first nine months of 2004. Of the increase, $48,000 relates to engineering activities in 2004 that were charged to cost of sales rather than research and development, as they related to enhancements to existing products. The remainder of the increase relates to increases in engineering labor, contract labor, shop labor and materials purchased for further development of the Criteria 20 that was under evaluation by a potential customer, offset by the impact of headcount reductions to the engineering staff made in August 2005.

Interest Expense

Interest expense consisted of $115,000 for borrowings under the Company s loan agreement, along with $36,000 amortization charges for deferred loan costs.

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Other Income - Net

Other income net decreased by $14,000, as a $37,000 charge to write down the value of investment securities was offset by a $22,000 increase in rental income and $1,000 of gains on the sale of miscellaneous assets.

Three months ended September 30, 2005 compared to three months ended September 30, 2004.

Revenues

Revenues in the third quarter of 2005 were $761,000, compared to $921,000 in the comparable period in 2004. Revenues declined in each of the Company s business segments as follows: Testing Products (4%), Services (9%) and Power Sources (44%).

Revenues in the Testing Products segment were $187,000 in the third quarter of 2005, compared to $194,000 in the 2004 period. The decrease is attributable to a decrease in spare parts sales.

Revenues in the Services segment were $432,000, compared to $475,000 in the prior year. The decrease is due to a reduction in burn-in and test revenues that resulted from a 29% decrease in units processed, partially offset by a 29% increase in average selling prices.

Revenues in the Power Sources segment were $142,000, compared to $252,000 in the prior year. The decrease is the result of a 40% decrease in units shipped and a 6% decrease in average selling prices. The decrease in average selling prices is due to a change in product mix, as sales in 2005 included fewer higher output devices.

Gross Profit

Gross margin increased from $92,000 for the quarter ended September 30, 2004 to $ 122,000 in the quarter ended September 30, 2005. Gross margin by industry segment for the periods is presented below (in thousands):

	Three Months Ended September 30	
	2005	2004
Testing Products	$ 28	$ 1
Services	91	45
Power Sources	3	46
Total	$ 122	$ 92

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The increase in margin in the Testing Products division is due to differences in product mix. The increase in gross margin in the Services segment is primarily due to a decrease in depreciation expense of $54,000 and a decrease in repairs and maintenance expense of $57,000, offset by an increase in utilities of $16,000, an increase in rent allocated to production departments of $13,000 and the impact of lower revenues. The decrease in gross margin in the Power Sources segment is due to lower revenues, product mix, as fewer high output devices, which carry higher margins, were sold, and a lower activity level, which resulted in less overhead costs being allocated to production costs, and ultimately inventory.

Marketing, General and Administrative

Marketing, general and administrative expenses decreased from $776,000 in the third quarter of 2004 to $584,000 in the comparable period in 2005. The primary causes of the decrease were a $76,000 decrease in corporate compliance costs and professional fees, a $38,000 decrease in amortization charges for demonstration equipment, a $28,000 decrease in engineering charges supporting specific sales efforts, a $29,000 decrease due to lower headcount and a $12,000 decrease in liability and casualty insurance.

Research and Development

Research and development costs were $80,000 in the quarter ended September 30, 2005, compared to $166,000 in the comparable period in 2004. The decrease is due to staff reductions in August 2005 in the Engineering department.

Interest Expense

Interest expense consisted of $53,000 for borrowings under the Company s loan agreement, along with $12,000 of amortization charges for deferred loan costs.

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Item 3. Controls and Procedures.

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

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

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OTHER INFORMATION

PART II - OTHER INFORMATION

September 30, 2005

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

Item 6. Exhibits and Reports on Form 8-K:

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

31.1 Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as Amended

31.2 Certification Pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as Amended

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

(b) Reports on form 8-K.

Not applicable

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SIGNATURES

September 30, 2005

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

RELIABILITY INCORPORATED
(Registrant)

November 14, 2005	/s/ LARRY EDWARDS **Larry Edwards** **President and Chief Executive Officer**
November 14, 2005	/s/ CARL V. SCHMIDT **Carl V. Schmidt** **Chief Financial Officer**