RELIABILITY INC
Form 10-K
March 17, 2004
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15 (d)

of the Securities Exchange Act of 1934

For the Fiscal Year Ended December 31, 2003 **Commission File Number 0-7092**

RELIABILITY INCORPORATED

(Exact name of registrant as specified in its charter)

TEXAS	**75-0868913**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
16400 Park Row **Post Office Box 218370** **Houston, Texas**	**77218-8370**
(Address of principal executive offices)	**(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 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 x 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-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12(b)-2 of the Act). YES ¨ NO x

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 the last business day of the registrant s most recently completed second fiscal quarter $6,391,050.

Common Stock, no par value	**6,335,965**
(Title of class)	**(Number of shares outstanding)**

as of March 8, 2004

Documents Incorporated by Reference

Listed hereunder are the documents incorporated by reference and the Part of the Form 10-K into which such documents are incorporated:

Part III Proxy Statement for the 2004 Annual Meeting of Shareholders of the Registrant (to be filed within 120 days of the close of the registrant s fiscal year)

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December 31, 2003

PART I

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PART I

Item 1. ***Business***

THE COMPANY

Reliability Incorporated is principally engaged in the design, manufacture, market and support of high performance equipment used to test and condition integrated circuits (Test and Conditioning Products). Reliability and its subsidiary (collectively referred to as Reliability or the Company) also designs, manufactures and markets a line of DC-DC power converters (Power Sources) and operates a service facility in Singapore that conditions and tests integrated circuits as a service for others (Services). In July 2003, the Company entered a new line of business (Automotive) by acquiring the rights to manufacture and market an aftermarket hydraulic lifting device that is installed in the bed of pickup trucks. The Company s strategy for each of these business segments is to target customers and other prospects who are market leaders, to provide high-quality products and services, to develop long-term relationships with its customers by investing in specific research and development to meet their needs, and to continuously reduce both the customers and the Company s cost and time to market.

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. The Company has one wholly owned subsidiary, Reliability Singapore, Pte Ltd. Reliability de Costa Rica, S.A. was shut down and dissolved in the third quarter of 2002, when its business was transferred to the parent company.

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 2003, Reliability had four operating segments based on its product and service offerings: Test and Conditioning Products, Services, Power Sources and Automotive. See **Note 4** of the Notes to Consolidated Financial Statements for financial information regarding segment reporting.

TEST AND CONDITIONING PRODUCTS

The Company has been providing leading technology capital equipment to IC manufacturers and users to burn-in ICs since 1975 and to functionally test ICs during burn-in since 1980. Reliability s burn-in and testing products contain sophisticated hardware and software, most of which are designed and manufactured at the Company s Houston, Texas facility.

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The Company was one of the first to design, manufacture and market systems that utilize burn-in and test technology within the same product. Historically, such equipment was used as a tool for engineering and quality assurance to qualify and evaluate new designs and diagnose defects and was not an integral part of the manufacturing process. Today, many IC manufacturers are implementing functional testing during burn-in as a part of the manufacturing process. Since 1992, the Company has focused its research and development 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 has led to the development of three major product families: INTERSECT, CRITERIA® 18, and CRITERIA 20.

INTERSECT memory test systems perform functional and long cycle tests on large quantities of memory devices in parallel during the conditioning (burn-in) process. This represents a difference in the way most memory devices have historically been tested. Traditionally, a significant amount of time was spent serially testing devices after they were conditioned using serial testers typically capable of testing 64 to 128 devices at a time. Because the INTERSECT systems can perform many of these same tests during the burn-in process in a massively parallel environment, and are less expensive than serial testers, IC manufacturers of DRAMs, SDRAMs and SRAMs can reduce final test cost by an estimated 30% to 60%. INTERSECT systems offer large test capacity, automated calibration, a fully algorithmic test generator, comprehensive software and networking via industry standard LAN.

CRITERIA 18 systems are designed for fine-line geometry micrologic devices (i.e., microprocessors) that dissipate large amounts of heat. The CRITERIA 18 offers total microprocessor control, solid state switching for low electrical noise, large system capacity with high current power buses, and the ability to dissipate up to 15,000 Watts of power in an economically sized system. The Company believes these features allow users to significantly reduce the amount of floor space required when performing burn-in or burn-in and test of low and medium power micrologic devices. The CRITERIA 18 systems offer a comprehensive software system and networking via industry standard LAN.

CRITERIA 20, introduced in July 2001, is the Company s newest generation burn-in and test system for medium and high power micrologic devices. The Company believes the CRITERIA 20 offers its customers a step function increase in system performance at an economical price. CRITERIA 20 systems include: high speed test electronics, delivery and control of large amounts of current at very low voltages, thermal management techniques to tightly control temperature gradient and large variations in dissipation from device to device, dissipation options up to 57,600 Watts of power, extensive self test, calibration and diagnostics, a comprehensive software system and networking via industry standard LAN.

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 capital cost has historically been shared by the Company and its customers, the Company is primarily responsible for providing the building and equipment required, along with the personnel and management to operate the facility.

The Company operates a services facility in Singapore that uses CRITERIA and INTERSECT systems to provide burn-in and burn-in test services for DRAM, SDRAM, SRAM, and microprocessors. The Company also uses related equipment acquired from others to provide serial testing, laser-marking, and tape and reel services. Services are generally sold on a periodically adjusted per-unit-processed basis to large volume semiconductor manufacturers that prefer to focus on their core business and technologies and to deploy their capital accordingly.

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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. These DC-DC converters allow 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 introduced its initial power source in 1972. Today the Company offers a wide range of DC-DC converters from 1 to 30 Watts. The Company focuses on developing specialized DC-DC converters for targeted customers within the telecommunications, computer and other industries that are adopting lower voltage components that operate at different voltages within the same equipment. The Company designs and markets power sources at its Houston, Texas facility and then makes the products available through its substantial distribution and representative network in the U.S. and Europe.

AUTOMOTIVE

In July of 2003, the Company acquired the intellectual property rights and related assets to manufacture and market a unique hydraulic lifting system (Ezy-Load™) that installs in the bed of pickup trucks without sacrificing valuable cargo space. Historically, cargo loading and unloading of pickup trucks has been a labor intensive, manual task requiring multiple people and involving risk of injury and damage to cargo when lifting, lowering, pushing and pulling large or heavy items into or out of the bed of the truck.

Ezy-Load lifting system is designed to fit most 1/2, 3/4 and 1 ton pickup trucks. The system operates from the vehicle s 12-volt battery, which provides power to the crane winch and the hydraulic power unit. The hydraulics are completely self-contained with a DC motor, gear pump, reservoir and load hold check valves to prevent overloading. Flow from the pump, to a pair of double-acting cylinders, provides the lift and rotation necessary to extend and retract the lift arms via a hand-held remote control. Ezy-Load allows a single person to easily lift, position, load and unload heavy or bulky cargo, up to 1,000 lbs., while standing clear of the load. The Company believes the Ezy-Load lifting system provides customers a safer work environment and will quickly pay for itself in reduced hand and back injuries caused by lifting and sliding heavy cargo manually. The product will initially be marketed directly by the Company in the Harris County, Texas area.

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 commits a significant portion of its resources to research and development programs for new products, services and enhancements to existing products. Research and development expenditures for the Company s four operating segments were $1.3 million in fiscal 2003. These expenditures were $2.5 million in fiscal 2002 and $2.9 million in fiscal 2001. Total research and development was 64% of revenue in 2003, compared to 62% in 2002 and 24% in fiscal 2001.

Research and development programs for the Test and Conditioning Products segment account for a significant portion of these expenditures. The Company s development activities are focused on solutions to meet the technical requirements created by continually shrinking geometries of the new generations of integrated circuits. The Company has developed new high speed test and interface electronics, methods to deliver large amounts of current at very low voltages, thermal management techniques to handle large variations in heat dissipation from device to device and methods to effectively manage higher power in a chamber operating at lower temperatures. Some of these features were introduced during fiscal 2000 and 2001 as retrofit enhancements

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to the Company s CRITERIA 18 product line. The CRITERIA 20, which was introduced in July of 2001, incorporates many of these features and provides a step function increase in performance compared to the Company s previous product offerings. The Company anticipates that it will continue to have significant research and development expenditures in the future to provide new products and enhancements to existing products, including the CRITERIA 20.

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 services, the technical skills of its personnel, and its ability to adapt to the changing technological requirements more than upon the protection of any proprietary rights. The Company holds several patents and has pending patent applications on certain components of its test and conditioning equipment, topology for regulated outputs of its DC-DC converters and lift arm linkage and positioning of its lifting systems.

Although the Company believes that its intellectual property has value and can provide it with a competitive advantage, no single patent is, in itself, critical to the Company as a whole or to any of its operating segments. While the Company attempts to protect its intellectual property through patents, copyrights, trade secrets, trademarks, and other means, there can be no assurance that these measures will be sufficient or provide significant competitive advantages.

RAW MATERIALS AND INVENTORY

The Company s products contain certain parts that it manufactures and assembles as well as components and assemblies purchased from others. In most cases, the Company is not a significant purchaser of raw materials from its suppliers and therefore has little control over either the availability or pricing of component parts for test and conditioning products, power sources or lifting systems. The Company maintains an inventory of components and parts for its manufacturing activities. There are many sources for most of the raw materials needed for the Company s manufacturing activities, although a few components come from sole sources. The Company has not experienced any significant inability to obtain components or parts, but does experience occasional delays and long lead times for certain items. The inability to acquire certain key components for an extended period of time could have a material adverse effect on the Company.

CUSTOMERS

The Company develops, markets and sells products for, and provides services to, semiconductor manufacturers and users of large quantities of ICs. Since development cost for products and the capital cost for services are high, the Company targets customers that it believes have the financial capacity to buy large enough quantities of products and services to provide the Company with a return on its investment. In addition, due to the fact that there are only a small number of companies that have a need to test and condition large batches of ICs, the potential customer base is limited. The Company s ability to maintain or increase its sales in the future will depend, in part, on its ability to obtain orders from its existing and new customers as well as the financial condition and success of its existing customers.

In 2003, sales to the Company s largest customers accounted for approximately 52% of its net sales, compared to 71% in fiscal 2002 and 78% in fiscal 2001. In 2003, Intel Corporation (Intel) and Alliance Semiconductor Corporation (Alliance) accounted for 28% and 24%, respectively, of the Company s net sales. During fiscal 2002, Intel, Alliance and Advanced Micro Devices, Inc. (AMD) accounted for 49%, 11%, and 11% of the

Company s net sales, respectively. In fiscal 2001 Intel, AMD, and Alliance accounted for 46%, 18%, and 14% of the Company s net sales, respectively. No other customer represented more than 10% of the Company s net sales during these periods. See also **Note 4** to the Consolidated Financial Statements.

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The Company expects that sales of its products and services to a limited number of customers will continue to account for a high percentage of net sales in its traditional business lines. Additionally, sales to a particular customer may fluctuate significantly from quarter to quarter and year to year. The loss of a key customer or any substantial reduction or delay in orders from any one customer could have a material adverse effect on the Company.

COMPETITION

The markets for the Company s products and services are subject to intense competition and are characterized by rapidly changing technology. The Company s competitors can be expected to continue to improve the design and performance of their products and to introduce new products with competitive price performance characteristics. Competitive pressures often necessitate price reductions that can adversely affect operating results. Although the Company believes that it has certain technological and other advantages over its competitors, maintaining such advantages will require a continued high level of investment by the Company in research and development, marketing and service.

The Company s primary competitors in the Test and Conditioning Products segment are other independent manufacturers of similar systems and manufacturers of ICs who design their own equipment. The primary methods of competition in this segment are product features, quality, service, delivery, and price. The Company believes that its service after the sale, including its ability to provide installation, maintenance service, and spare parts, enhances its competitiveness.

The primary areas of competition for the Company s Services are price, service level and geographic location. The Singapore Services facility provides services to IC users and manufacturers in Singapore and Southeast Asia.

The world market for power sources is divided into the merchant and the captive markets. The Company estimates there are more than 1,000 competitors in the merchant market of the power sources manufacturing business, most of which target a particular application for their business. The Company believes there are approximately 20 to 30 significant competitors whose products compete directly with those of the Company in its U.S. and foreign markets. Competition in the power sources market is based primarily on the specific features of the power sources, price and quality.

The primary competitors for Ezy-Load are other independent manufacturers of lift gates and light duty cranes for pickup trucks. Price, quality and geographic location are the primary competitive factors for this segment. The Company believes that the ability to provide installation, maintenance service and spare parts are the key elements of enhanced competitiveness.

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BACKLOG

Backlog for sales of Test and Conditioning Products, Power Sources and Automotive represents orders for delivery within 12 months from the date on which backlog is reported. Backlog for Services represents orders for services where the ICs to be conditioned and/or tested have been delivered to the Company for processing. The Company s believes its backlog as of December 31, 2003, is firm, although portions of the backlog are not subject to legally binding agreements.

The following table sets forth the Company s backlog of its segments at the dates indicated:

	December 31,	
Business Segment	**2003**	**2002**
	(In thousands)	
Testing Products	$ 8	$ 61
Services	69	7
Power Sources	88	31
Automotive		
Total	$ 165	$ 99

EMPLOYEES

As of December 31, 2003, the Company had 88 employees worldwide, of which seven were contract or temporary employees. The Company s success is in part dependent on its ability to attract and retain its technical staff and skilled employees. During recent years, the Company has experienced a low turnover rate among its U.S. employees. None of the Company s employees are represented by a labor union. The Company has not experienced any work stoppages and considers its relations with its employees to be good.

INTERNATIONAL OPERATIONS

The Company is domiciled in the United States and operates a service facility in Singapore. It sells products to customers for delivery outside of the U.S. Consequently, the Company is subject to risk customarily found in international business operations, such as fluctuation of currency exchange rates, import and export controls, regulatory policies of foreign governments, longer receivable collection periods and greater difficulty in accounts receivable collections. The Company attempts to conduct its business and financial affairs so as to protect against political and economic risk, but there can be no assurance that the Company will be successful in protecting itself. **See Note 4** of the Notes to Consolidated Financial Statements for financial information regarding segment reporting and geographic areas.

ENVIRONMENTAL MATTERS

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

SEASONALITY

The Company s business in not seasonal but is very cyclical, depending on the growth of the semiconductor and electronics equipment industries.

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GOVERNMENTAL BUSINESS

The Company does not have a material amount of business with any governmental agency.

Item 2. ***Properties.***

The Company s headquarters and principal administrative, engineering and manufacturing facility is located in a 131,000 square foot facility on a seven acre tract of land in Park 10, an office and industrial park located on the west side of Houston, Texas. The Company leased this property until March 1995, when it purchased the property. All indebtedness related to the facility has been paid and all liens released. The Company occupies 96,000 square feet of the facility and leased the remaining 35,000 square feet to an unrelated party until August 2003. The Company is actively seeking a new tenant to occupy this vacant space. The Company s Services subsidiary is located in a 33,600 square foot facility in Singapore under a lease that expires in 2006.

As of December 31, 2003, the Company also owned a 43,500 square foot facility on a seventeen and one- half acre tract of land in Durham, North Carolina. This facility is debt free and unencumbered. In January of 2003, the Company completed the sale of its San Jose, Costa Rica facility to an unrelated party. The Durham facility is actively being marketed for sale or lease and a portion of the facility is currently leased on a month-to-month basis to an unrelated party.

The Company considers its properties suitable and sufficient for its needs and has no current plans to expand or relocate. **See Note 8** to the Company s Consolidated Financial Statements for information concerning leases and **Note 11** for financial information on the sale of the Costa Rica facility.

Item 3. ***Legal Proceedings.***

Not applicable.

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

Not applicable.

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Item 4A. ***Executive Officers of the Registrant.***

Executive officers of the Company as of December 31, 2003 were as follows:

Name	Age	Officer of Reliability Incorporated Since	Position Currently Held with Reliability Incorporated
Larry Edwards	62	1981	Chairman of the Board of Directors, President and Chief Executive Officer
James M. Harwell	49	1993	Executive Vice President and Chief Operating Officer
Paul Nesrsta	47	1993	Vice President
Carl Schmidt	47	2003	Chief Financial Officer, Secretary and Treasurer

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. Harwell was appointed Executive Vice President and Chief Operating Officer in July 2003. Mr. Harwell is also responsible for the operations of the Company s Power Sources and Automotive segments. From November 2002 until July 2003, he served as Executive Vice President and Acting Chief Financial Officer. He was Vice President, Operations from 1996 until 2002, Vice President, Site Services from 1993 until 1996 and the division manager of the automation equipment division of the Company from 1991 to 1993.

Mr. Nesrsta was appointed Vice President, Testing Products Marketing and Engineering in November 2003. From 1996 until November 2003, he served as Vice President, Sales and Marketing. He was Vice President, Testing Products Marketing from 1993 until 1996 and was manager of the test systems division of the Company for more than five years prior to becoming a vice president in 1993.

Mr. Schmidt joined the Company in December 2002 as Director of Accounting and Finance and was appointed Chief Financial Officer, Secretary and Treasurer in July 2003.

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PART II

Item 5. ***Market for the Registrant s Common Stock and Related Stockholder Matters.***

The common stock of Reliability trades on The Nasdaq Stock Market under the stock symbol REAL. The high and low sale prices for 2003 and 2002, as reported by The Nasdaq Stock Market, are set forth below.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2003				
High	$ 1.43	$ 1.18	$ 1.46	$ 1.39
Low	.71	.76	1.06	1.05
2002				
High	$ 3.12	$ 3.05	$ 2.50	$ 1.42
Low	2.03	2.21	1.31	.98

The Company paid no cash dividends in 2003 or 2002. The Company intends to retain earnings for use in its business and therefore does not anticipate paying dividends in the foreseeable future. See **Note 3** to the accompanying financial statements, which describes restrictions on the Company s subsidiary to pay dividends.

The Company has only one class of stock, which is common stock with full voting rights. In 2001, the Company sold and issued shares of common stock to its key employees, officers and directors who exercised stock options. All common stock shares issued under the stock option plan in 2001 were registered under Registration Statements on Form S-8.

Reliability had approximately 691 shareholders of record as of February 16, 2004. Management estimates there are approximately 3,000 beneficial owners of Reliability common stock.

The following table sets forth the number of shares of the Company s common stock reserved for issuance under the Company s equity compensation plan as of December 31, 2003:

	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Plan category	(a)	(b)	(c)

Equity compensation plans approved by security holders	839,000	$ 2.66	444,000
Equity compensation plans not approved by security holders			
Total	839,000	$ 2.66	444,000

Shares of Company stock are also used to fund the matching feature of the Employee Stock Savings Plan. See **Note 7** to the Consolidated Financial Statements.

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Item 6. ***Selected Financial Data.***

The following table sets forth certain selected financial data for the years indicated:

	Years Ended December 31,				
	2003	**2002**	**2001**	**2000**	**1999**
	(In thousands, except per share data)				
INCOME STATEMENT DATA:					
Revenues	$ 2,042	$ 4,041	$ 12,082	$ 22,235	$ 16,551
Cost of revenues	3,403	4,351	9,453	12,606	10,750
Gross profit	(1,361)	(310)	2,629	9,629	5,801
Expenses:					
Marketing, general and administrative	3,265	4,018	4,978	6,421	5,540
Research and development	1,310	2,498	2,932	1,561	1,654
Provision for asset impairments restructuring and shut-down	967	2,146	420	416	800
Relocation expenses				390	
Total expenses	5,542	8,662	8,330	8,788	7,994
Interest income, net	57	132	609	956	649
Other income	185				
Income (loss) before income taxes	(6,661)	(8,840)	(5,092)	1,797	(1,544)
Provision (benefit) for income taxes	(122)	(3,751)	(745)	746	(288)
Net income (loss)	$ (6,539)	$ (5,089)	$ (4,347)	$ 1,051	$ (1,256)
Earnings (loss) per share (1):					
Basic	$ (1.03)	$ (.80)	$ (.67)	$ .16	$ (.19)
Diluted	&				