PALLET MANAGEMENT SYSTEMS INC
Form 10-Q
May 14, 2002

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the thirteen-week period ended
March 30, 2002

Commission File Number 000-24405

PALLET MANAGEMENT SYSTEMS, INC.
(Exact name of registrant as specified in its charter)

Florida	59-2197020
(State or other jurisdiction of incorporation)	(IRS Employer Identification Number)

2855 University Drive, Suite 510, Coral Springs, Florida 33065
(Address of principal executive offices)

Registrant's telephone number, including area code:
(954) 340-1290

(Former name or address if changed since last report)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

On May 14, 2002, the Registrant had outstanding 4,187,612 shares of common stock, $.001 par value.

PALLET MANAGEMENT SYSTEMS, INC.
CONSOLIDATED BALANCE SHEETS

	March 30, 2002 (unaudited)	June 20

ASSETS		
CURRENT ASSETS		
Cash	$ 13,385	$ 2
Accounts receivable - trade, net of allowance for doubtful accounts	$ 1,636,982	$ 4,6
Inventories	$ 2,930,187	$ 2,0
Other Current Assets	$ 305,582	$ 2
Total current assets	$ 4,886,136	$ 7,1
Property and equipment - net of accumulated depreciation	$ 5,254,838	$ 5,6
OTHER ASSETS	$ 92,722	$
Total assets	$ 10,233,696	$ 12,8
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Current maturities of long-term debt	$ 4,882,144	$ 4
Current portion of capital lease obligations	$ 140,766	$ 1
Accounts payable	$ 1,553,523	$ 3,0
Accrued liabilities	$ 786,705	$ 5
Total current liabilities	$ 7,363,138	$ 4,0
LONG-TERM DEBT		
Long-term debt	$ 135,400	$ 5,4
Capital lease obligations	$ 167,893	$ 1
Total long-term liabilities	$ 303,293	$ 5,5
Total liabilities	$ 7,666,431	$ 9,6
STOCKHOLDERS' EQUITY		
Preferred stock, authorized 7,500,000 shares at $.001 par Value; no shares issued and outstanding		
Common stock, authorized 10,000,000 shares at $.001 par value; issued and outstanding 4,187,612 shares at March 30, 2002 and 4,065,612 June 30, 2001	$ 4,188	$
Additional paid in capital	$ 7,148,592	$ 7,2
Accumulated deficit	$ (4,447,515)	$ (3,7
Notes receivable from stockholders	$ (138,000)	$ (2
Total stockholders' equity	$ 2,567,265	$ 3,2
Total liabilities and stockholders' equity	$ 10,233,696	$ 12,8

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

PALLET MANAGEMENT SYSTEMS, INC.
CONSOLIDATED STATEMENT OF OPERATIONS
(Unaudited)

	13 Weeks Ended		39 Wks
	March 30, 2002	March 31, 2001	March 3
Net sales	$ 8,691,034	$ 12,374,407	$ 37,3
Cost of goods sold	$ 8,223,874	$ 11,593,615	$ 35,1
Gross profit	$ 467,160	$ 780,792	$ 2,1
Selling, general and administrative expense	$ 856,369	$ 802,917	$ 2,5
Operating profit (loss)	$ (389,209)	$ (22,125)	$ (3
Other income (expense)			
Other income (expense)	$ 7,525	$ 29,717	$ (
Interest expense	$ (87,564)	$ (111,981))	$ (2
Total other income (expense)	$ (80,039)	$ (82,264)	$ (3
Income (loss) before income tax expense	$ (469,248)	$ (104,389)	$ (6
Income tax expense (benefit)	$ --	$ --	$
Net income (loss)	$ (469,248)	$ (104,389)	$ (6
Net earnings (loss) per common share	$ (0.11)	$ (0.03)	$
Diluted earnings (loss) per common share	*	*	

* exercise of warrants and options would be anti-dilutive

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

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PALLET MANAGEMENT SYSTEMS, INC.
CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited)

	39 Wks Ended March 30, 2002	4 M
Cash flows from operating activities:		
Net income (loss)	$ (671,343)	
Adjustments to reconcile net income (loss) to net cash provided by/(used in) operating activities:		
Depreciation	$ 530,453	
Loss on disposal of assets and investments	$ --	
Stock Options issued for Services	$ 17,158	
(Increase) Decrease in operating assets:		
Accounts receivable	$ 2,977,629	
Inventories	$ (888,698)	
Other assets	$ (47,658)	
Increase (Decrease) in operating liabilities:		
Accounts payable	$(1,486,043)	
Accrued liabilities	$ 496,625	
Net cash provided by/(used in) operating activities	$ 928,123	
Cash flows from investing activities:		
Other assets	$ --	
Purchase of fixed assets	$ (185,769)	
Proceeds from Disposal of fixed assets	$ 40,834	
Net cash used in investing activities	$ (144,935)	
Cash flows from financing activities:		
Net Borrowings from lenders	$ --	
Net Payments of long term debt	$(1,002,438)	
Net cash provided by/(used in) financing activities	$(1,002,438)	
Increase/(Decrease) in cash	$ (219,250)	
Cash at beginning of period	$ 232,635	
Cash at end of period	$ 13,385	

The accompanying notes are an integral part of these financial statements

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Pallet Management Systems, Inc.
Notes to Financial Statements
March 30, 2002

NOTE 1. CONSOLIDATED FINANCIAL STATEMENTS:

The consolidated balance sheet as of March 30, 2002, the consolidated statements of operations and cash flows for the thirty-nine week period ended

March 30, 2002 and forty week period ended March 31, 2001 and consolidated statements of operations for the thirteen week periods ending March 30, 2002 and March 31, 2001 have been prepared by the Company without audit in accordance with generally accepted accounting principles for interim financial information and with instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments necessary to present fairly the financial position, results of operations and cash flows for the periods reported have been made. Operating results for the thirty-nine weeks ended March 30, 2002 are not necessarily indicative of the results that may be expected for the year ended June 29, 2002. These consolidated financial statements should be read in conjunction with the financial statements and the notes thereto included in the Company's annual report filed on Form 10-K as of June 30, 2001.

Certain prior year amounts within the accompanying financial statements have been reclassified to conform to the current period presentation.

NOTE 2. DEBT AGREEMENT

The Company has a revolving loan and three term loans with La Salle Business Credit in a three year agreement, which commenced April 14, 2000. The Company did not pass the Consolidated Tangible Net Worth, the Consolidated Interest Coverage Ratio or the Consolidated Debt Service Coverage Ratio due to the net loss for the thirty-nine weeks ending March 30, 2002 of ($671,000) compared with the net income for the forty weeks ending March 31, 2001 of $207,000. As of March 30, 2002 the Company received waivers for its loan covenants. The waivers were accompanied by a 50 basis point increase to our borrowing rate on all of the loans.

Advances under the revolving agreement are based on the sum of 85% of eligible accounts receivable, plus the lesser of 55% of eligible inventories or $2,500,000. Interest is paid monthly at the bank's prime rate plus one point five percentage points. Principal is due in April 2003, with possible year to year renewals thereafter. The revolving agreement is collateralized by substantially all of the assets of the Company. At March 30, 2002, the Company had $ 1,220,000 of availability under the revolving agreement.

The three term loans as of March 30, 2002 were at $1,122,000, $1,322,000 and $ 894,000. These loans are collateralized by substantially all the assets of the Company. The Company has reclassified the debt from LaSalle Business Credit from Long-Term to Short-Term due to the probability that the loan covenants will not be met in the coming twelve months. The Company is continuing to work on its financing needs, as well as focusing on improving operating results to decrease this probability.

NOTE 3. INVENTORIES

Inventories consisted of the following at March 30, 2002:

Raw material	$1,071,202
Work in process	$ 277,317
Finished goods	$1,581,668
TOTAL	$2,930,187

NOTE 4. NET EARNINGS (LOSS) PER SHARE OF COMMON STOCK:

Net earnings (loss) per share of common stock was determined by dividing net income (loss) applicable to common shares by the weighted average number of common shares outstanding during each period. Diluted earnings/(loss) per common share reflects the potential dilution that could occur assuming exercise of all issued and unexercised stock options. A reconciliation of the net income/(loss) and numbers of shares used in computing basic and diluted earnings/(loss) per common share is as follows (in thousands, except per share data):

	39 Weeks Ended March 30 2002	40 Weeks Ended March 31 2001
Basic earnings/(loss) per common share:		
Net income/(loss)	($ 671)	$ 207
Weighted average common shares outstanding for the period	4,110	4,065
Basic earnings per share of common stock	($ 0.16)	$ 0.05
Diluted earnings/(loss) per common share:		
Net income/(loss)	($ 671)	$ 207
Weighted average common shares outstanding for the period	4,110	4,065
Increase in shares which would result from exercise of stock options	*	256
Weighted average common shares, assuming conversion of the above securities	*	4,321
Diluted earnings/(loss) per share of common stock	*	$ 0.05

* exercise of warrants and options would be anti-dilutive

NOTE 5. LITIGATION

In June 1999, the Company was named as a co-defendant in a lawsuit whereby the plaintiff is alleging damages of up to $300,000 related to lost income from a facility and other property formerly leased to the Company in Jessup, Maryland. Management believes the claim is without merit and intends to vigorously contest the claim. St. Paul Insurance is currently paying defense costs. The outcome of the action as well as the extent of the Company's liability, if any, can not be determined at this time.

The Company's Board of Directors terminated the employment of Mr. Zachary Richardson as President of the Company effective March 15, 2002. Prior to the date of termination, Mr. Richardson notified the Company in writing that he would consider any such termination to be a breach of his Employment Agreement and that the Company would owe him approximately $675,000. The Company disagrees with Mr. Richardson's contention and would defend vigorously against any claim brought by Mr. Richardson in this regard.

NOTE 6. REVENUE RECOGNITION

Sales revenue is generally recorded upon the delivery of goods or the acceptance of goods by the customer according to contractual terms and represents amounts realized, net of discounts and allowances.

NOTE 7. ACCOUNTING FOR SOFTWARE RELATED COSTS

The Company accounts for the costs of computer software developed or obtained for internal use in accordance with Statement of Position 98-1 which generally requires the capitalization of costs incurred during the application development stage of computer software meeting certain characteristics. All costs incurred during the preliminary project stage and post implementation / operation stage are expensed as incurred.

NOTE 8. NEW ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 141, "Business Combinations" (SFAS 141), which applies to all business combinations initiated after June 30, 2001. This statement requires that all business combinations be accounted for by the purchase method and defines the criteria used to identify intangible assets to be recognized apart from goodwill.

In June 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" (SFAS 142), which is effective for fiscal years beginning after December 15, 2001, except goodwill and intangible assets acquired after June 30, 2001 are subject immediately to the non-amortization and amortization provisions of this Statement. Under the new rules, goodwill and intangible assets deemed to have indefinite lives will no longer be amortized but will be subject to annual impairment tests in accordance with the Statement. Other intangible assets will continue to be amortized over their useful lives.

In August 2001, the Financial Accounting Standards Board Issued Statement of Financial Accounting Standards No. 143 "Accounting for Asset Retirement Obligations", effective for fiscal years beginning after June 15, 2002. This statement addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated retirement costs.

In October 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 144 "Accounting for the Impairment or Disposal of Long-lived Assets", effective for fiscal years beginning after December 15, 2001. This statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets.

The Company has not yet determined what the effects of these Statements will be on its financial position and results of operations.

NOTE 9. STOCKHOLDERS' EQUITY

In October 2001, the Company granted options to purchase approximately 660,000 shares of common stock to employees and directors of which 280,000 were granted to the President. 460,000 of these options vested upon grant while the remainder vest through July 1, 2006.

In December 2001, the President of the Company exercised options to acquire 280,000 shares of common stock through the transfer of 88,000 mature shares. Upon exercise, the President was granted "reload" options to acquire 88,000 shares of common stock at $1.75 per share.

Also in December 2001, the President transferred 70,000 shares of common stock to the Company in satisfaction of his note payable to the Company in the amount of $138,000, as permitted by the original terms of the note.

NOTE 10. MANAGEMENT CHANGES

In March 2002, the Company's Board of Directors appointed Robert L. Steiler as the interim leader of the company's executive management after terminating the employment of Zachary M. Richardson as President. The Board of Directors appointed a special committee from its members to conduct a search for a new President of the Company. Mr. Steiler has been a Director of the Company since April 2000 and was a business consultant to the Company from February 2000 to June 2001.

PART I

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

The following discussion and analysis should be read in conjunction with the financial statements appearing as Item 1 to this Report and the Form 10-K for the year ended June 30, 2001. The financial statements in this Report reflect the consolidated operations of Pallet Management Systems, Inc. (the "Company" or "Pallet Management") for the thirteen-week and thirty-nine-week periods ended March 30, 2002 and for the thirteen-week and forty week periods ended March 31, 2001.

The following discussion regarding Pallet Management and its business and operations contains "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. These statements consist of any statement other than a recitation of historical fact and can be identified by the use of forward-looking terminology such as "may," "expect," "anticipate," "estimate" or "continue" or the negative thereof or other variations thereon or comparable terminology. The reader is cautioned that all forward-looking statements are necessarily speculative and there are certain risks and uncertainties that could cause actual events or results to differ materially from those referred to in such forward-looking statements, including the limited history of profitable operations, dependence on CHEP, competition, risks related to acquisitions, difficulties in managing growth, dependence on key personnel and other factors discussed under "Risk Factors" in the Annual Report on Form 10-K for the year ended June 30, 2001. Pallet Management does not have a policy of updating or revising forward-looking statements and thus it should not be assumed that silence by management of Pallet Management over time means that actual events are bearing out as estimated in such forward-looking statements.

Critical Accounting Policy

Options granted to employees under the Company's Stock Option Plan are accounted for by using the intrinsic method under APB Opinion 25, Accounting for Stock Issued to Employees (APB 25). In October 1995, the Financial Accounting Standards Board issued Statement No. 123, Accounting for Stock-Based Compensation (SFAS123), which defines a fair value based method of accounting for stock options. The accounting standards prescribed by SFAS 123 are optional and the Company has continued to account for stock options under the intrinsic value method specified in APB 25. Pro forma disclosures of net earnings and earnings per share have been made in accordance with SFAS 123.

Results of Operations

General

Pallet Management has grown to be one of the largest pallet companies in the estimated $6 billion U.S. pallet industry, by providing value-added products and services to our customers. Our customer base has remained stable.

The majority of our revenues have traditionally been generated from providing high quality, specially engineered pallets to manufacturers, wholesalers and distributors. As supply chain logistics have become increasingly complex, our existing customers as well as prospective customers are seeking new ways to streamline distribution and reduce costs, which is opening a service-orientated market for us.

With this shift in focus toward services and cost efficiency, we are providing "state of the art" logistical services known as reverse logistics. Reverse logistics is simply defined as maximizing the use of transport packaging, the base of which is the pallet, by reusing assets to reduce the overall cost per trip.

This shift in focus toward supply chain efficiency by our customer base is by far our industry's most dramatic shift in focus and provides the most opportunity for our company. Driven mainly by economics, reusable packaging in a reverse logistics system also has environmental marketing benefits.

Reverse logistics, a sub-industry of the logistics industry, is growing rapidly and is estimated to have reached $7.7 billion. The third-party logistics industry is estimated to be in excess of $35 billion and growing rapidly as companies are discovering the benefits of outsourcing their logistical demands.

The Company has two lines of revenue, manufacturing and services:

Manufacturing: Our Company has two primary categories of manufacturing: CHEP grocery pallets and specifically engineered niche market pallets. The Company has had multi-year contracts to manufacture high quality grocery pallets for CHEP, the world's largest pallet rental pool. The Company is currently operating two manufacturing facilities, which currently produce CHEP pallets; Bolingbrook, Illinois and Plainfield, Indiana. In Rogersville, Alabama, our contract expired on September 7th, 2001 and the Company has ceased operations in that facility. In Bolingbrook, Illinois, our contract expired on April 30th, 2002 and in Plainfield, Indiana, our contract expires on March 1, 2003. The Company is considering closing the Bolingbrook, Illinois facility before the end of this fiscal year and is currently winding down operations.

Pallets that are specially engineered to transport a specific product are classified as niche market pallets. Besides CHEP, our Company's customer base is primarily composed of customers who require niche pallets. Niche pallets are lower volume and higher margin than CHEP pallets.

Pallet Management functions as a wholesale distributor of other various returnable transport packaging such as plastic and metal pallets; collapsible plastic bulk boxes; wood, plastic, and metal slave pallets; wooden boxes and crates; and various other products. Due to lack of demand, sales of pallets made from materials other than wood are minimal.

Services: Our Company provides a variety of retrieval, sortation, repair, warehouse and return services that enable our customers to better utilize their packaging assets. Besides being environmentally friendly, a properly repaired used pallet will provide the customer significant savings over having to buy a new pallet. Despite recent increases in levels of automation, pallet return operations remain a labor-intensive process.

Pallet users currently discard a large portion of new pallets after one use. The condition and size of these pallets vary greatly. The pallets are sorted and repaired as needed, placed in storage and made available for return to service. Pallets that can be repaired have their damaged boards replaced with salvaged boards or boards from new stock inventoried at the facility.

Pallets that cannot be repaired are dismantled and the salvageable boards are recovered for use in repairing and building other pallets. Pallet Management sells the remaining damaged boards to be ground into wood fiber, which is used as landscaping mulch, fuel, animal bedding, gardening material and other items.

As part of the Company's strategy to use the Internet to improve the effectiveness of its service offerings, it developed PalletNetTM , a service brand providing a logistics and information system that manages the flow of shipping platforms and containers throughout industrial supply chains (excluding the grocery industry). PalletNetTM creates a closed loop delivery, recovery and recycling system, which enables customers to treat pallets as assets rather than expendables.

The principal services PalletNetTM offers include reverse distribution, single source national contracts, high quality shipping platforms and transport packaging, recovery, repair, recycling and export packaging. These physical activities are supported by leading edge technology that enables users to improve shipping asset controls and reduce cost and waste from the supply chain, while reducing inventories and enhancing customer satisfaction. By coupling PalletNetTM with the Internet, the Company is creating value for the customer through substantially lower costs and improved efficiencies.

The PalletNetTM Application is an Internet Explorer browser-based user interface which delivers secure access to customers who can view exactly where their shipping platforms and containers are in the supply chain at any given moment. PalletNetTM has the capability to use information from either bar codes or radio frequency identification tags to track individual pallets and the equipment transported on them. These new logistical and information systems provide customers and Pallet Management the technical support requirements to manage an efficient reverse distribution operation and the management of valuable transport packaging from one location to another.

Pallet Management has hired key sales personnel during this fiscal year to expand its service offerings and service revenues. Until the newly hired sales personnel are trained, there will be an increase in the Selling, General and Administrative expenses as a percentage of sales. In addition, the cycle for completing a sale of services is significantly longer than that for selling manufactured pallets. We anticipate that service will become a greater percent of net sales as our new sales force begins to move forward.

Thirteen Weeks Ended March 30, 2002 compared to Thirteen Weeks Ended March 31, 2001

For the thirteen-week period ended March 30, 2002, net sales decreased 30% to $ 8,691,000 from $ 12,374,000 for the comparable fiscal year 2001 period. This decrease is primarily due to the second quarter closing of our Alabama facility whose sales were reduced $ 2,275,000 from the comparable period in fiscal year 2001, as well as reduced demand for niche pallets from the Lawrenceville, Virginia facility.

During the thirteen-week period ended March 30, 2002, manufacturing sales decreased 32% to $ 8,226,000 from $ 12,011,000. The decrease in manufacturing sales was primarily due to the reduction of orders received from our major customer at our Alabama and Illinois facilities, as well as a general slow down of orders received in the niche pallet sales at the Lawrenceville, Virginia location. The Alabama facility was closed in September 2001 and generated no sales during the thirteen week period ending March 30, 2002 as compared to $2,275,000 in the comparable period from fiscal year 2001. The Illinois facility remained with low demand from our major customer and generated $ 507,000 in fewer sales during the thirteen-week period ending March 30, 2002 from the comparable period from fiscal year 2001. The Lawrenceville, Virginia location continued to show soft demand for the niche pallets, as sales were down $816,000 from the comparable thirteen-week period in the prior year.

Service sales increased by 28% to $ 465,000 from $ 363,000. This increase in service sales is primarily due to our key customer placing steady orders throughout the thirteen-week period ending March 30, 2002 compared with the decline in orders during March 2001 made at the Petersburg, Virginia facility.

Pallet Management had a 7% increase in its selling, general and administrative expenses from $ 803,000 to $ 856,000 for the thirteen week period ended March 30, 2002 when compared to the thirteen week period ended March 31, 2001. The increase in selling, general and administrative expenses is primarily due to the addition of salespersons not on board during the prior fiscal year, which is offset by the reduction of consulting expense over the comparable thirteen week period from fiscal year 2001. Full time employees were hired to handle the workload that consultants previously provided causing a reduction to expenses. The sales team was expanded during the first twenty-six weeks of the fiscal year to six salespersons. In an effort to gain further cost control, the Company consolidated the sales department with new business development and reduced its staffing by the end of the thirteen week period to four salespersons.

A loss of ($ 469,000) or ($.11) per share was realized during this thirteen-week period ended March 30, 2002 compared to a loss of ($ 104,000) or ($.03) per share recorded for the thirteen-week period last fiscal year. The primary reasons for the loss was due to the low demand from our main customer in our Alabama, Illinois and Indiana facilities whose sales were off $ 2,969,000 for the thirteen week period ending March 30, 2002 from the comparable thirteen week period in the prior quarter. Additionally, we continued to see lower than

expected demand for our niche pallets from our Lawrenceville, Virginia facility as our newly hired salespersons began bringing in new accounts. Pallet

Management anticipates that the fourth quarter demand from our largest customer will remain slow, and that our niche pallet and service sales will begin to see some growth over the third quarter levels. We have continued cost control measures and are operating under strict budget guidelines and reduced staffing to reduce the impact to income that these reduced demands may cause.

Thirty-nine Weeks Ended March 30, 2002 compared to Forty Weeks Ended
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March 31, 2001

For the thirty-nine week period ended March 30, 2002, net sales decreased 30% to $ 53,458,000 from $ 37,386,000 for the forty-week period ended March 31, 2001. This decrease is primarily due to the reduction in orders from our Alabama facility, which was closed in September 2001. For the thirty-nine week period ending March 30, 2002, the Alabama sales decreased to $ 1,274,000 from $ 11,832,000 for the forty-week period ending March 31, 2001, an 89% reduction. Additionally, manufacturing sales from the Lawrenceville, Virginia plant for the thirty-nine week period ending March 30, 2002 decreased to $4,372,000 from $7,401,000 for the forty-week period ending March 31, 2001, a 41% reduction. This decreased has been due to soft demand from our customer base starting in January 2001 and not returning during the fall season as many of our large customers faced economic and cost cutting issues within their own businesses.

During the thirty-nine-week period ended March 30, 2002, manufacturing sales decreased 31% to $ 36,042,000 from $ 51,997,000 for the forty-week period ended March 31, 2001. The decrease in manufacturing sales was primarily due to the Alabama facility closing as described above, as well as reduced orders from our Illinois facility as our primary customer changed its ordering to a just in time philosophy and reduced its overall demand. The Illinois facility had reduced sales over the prior year by $ 2,831,000. In addition to the above, we have not increased our niche/specialty pallet sales from our Lawrenceville, Virginia facility. That facility showed fewer sales over the prior year by $3,029,000 caused by a softening market as our customers look to hold down costs and reduce expenditures.

Service sales decreased by 8% to $ 1,343,000 from the $ 1,461,000 recorded for the forty-week period ended March 31, 2001. The decrease in services is primarily due to the reduction of repair services made at the Petersburg, Virginia facility as a result of reduced demand during the first twenty-six weeks of our fiscal year from the comparable twenty-seven weeks of the prior fiscal year from the facility's key customer.

We experienced a 15% decrease in selling, general and administrative expenses from $ 3,006,000 to $ 2,557,000 for the thirty-nine-week period ended March 30, 2002 when compared to the forty-week period ended March 31, 2001. The decrease in selling, general and administrative expenses is primarily due to the reduction of consulting expense. The consulting expense reduction was made as we currently have full time employees handling the workload that consultants previously provided, causing a reduction to overall expenses by approximately $250,000. Selling, general and administrative expenses were also reduced by the initiative of the company to hold down costs for travel, telephone and legal expenses. Additionally, we had increased premiums for our insurance in fiscal year 2001, which were favorably re-negotiated for fiscal year 2002 and have generated a savings in excess of $ 100,000.

A net loss of ($ 671,000) or ($ 0.16) per share was recorded during this thirty-nine week period ended March 30, 2002 compared to a net income of

$207,000 or $0.05 per share recorded for the forty week period ended March 31, 2001. During the forty-week period ended March 31, 2001 we had consistent sales from our key customer and had begun to see a decline in our niche pallet customer base. During the thirty-nine week period ended March 30, 2002 we continued to see our niche pallet sales decline and, additionally, started to see low demand levels from our key customer. Our Alabama facility was closed and demand from our Illinois facility was further reduced. Between the Alabama and Illinois facility, which services our key customer, we saw reduced sales of approximately $ 13,389,000.

The Company began cost cutting measures in November 2001 in anticipation of reduced demand. The demand dropped below expectations, as March 2002 saw no increase in orders. The Company began a direct mailing campaign to generate more sales. The Company will focus on sales and marketing as we complete our fiscal year under a continued reduced demand from our key customer. The Company is currently looking for a tenant for its Illinois facility and anticipates closing this facility within the next quarter. We have continued cost control measures and are operating under strict budget guidelines and reduced staffing to reduce the impact to income that the reduced demand may cause.

Liquidity and Capital Resources

Pallet Management Systems had $13,000 cash on hand at March 30, 2002, versus $233,000 at the beginning of the fiscal year. The decrease in cash is primarily attributed to the year to date net loss and the build of inventory which was done in anticipation of increased March 2002 demand from our key customer which did not occur, as well as the timing of our payables and receivables. The cash used in financing activities is primarily due to repayments on the revolver and term loans to LaSalle Business Credit ($1,002,000). Net cash provided by operating activities of $ 775,000 is primarily due to a decrease in our accounts receivables balance of $ 2,978,000 due to the lower balance associated with our primary customer in March 2002 as compared with June 2001 primarily caused by the Alabama facility closing and the reduced order rate.

The Company believes that existing cash on hand, cash provided by future operations including PalletNetTM services, and additional available borrowings under its current line of credit will be sufficient to finance its operations and expected working capital and capital expenditure requirements for the remainder of this fiscal year. The Company's net working capital is at a negative ($3,136,000) due to the Company reclassifying the debt from LaSalle Business Credit from Long-Term to Short-Term. This is due to the probability that the loan covenants will not be met in the coming twelve months. The Company is continuing to work on its financing needs, as well as focusing on improving operating results to decrease this probability.

PART II - OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In June 1999, the Company was named as a co-defendant in a lawsuit whereby the plaintiff is alleging damages of up to $300,000 related to lost income from a facility and other property formerly leased to the Company in Jessup, Maryland. Management believes the claim is without merit and intends to vigorously contest the claim. St. Paul Insurance is currently paying defense costs. The outcome of the action as well as the extent of the Company's liability, if any, can not be determined at this time.

The Company's Board of Directors terminated the employment of Mr. Zachary Richardson as President of the Company effective March 15, 2002. Prior to the date of termination, Mr. Richardson notified the Company in writing that he would consider any such termination to be a breach of his Employment Agreement and that the Company would owe him approximately $675,000. The Company disagrees with Mr. Richardson's contention and would defend vigorously against any claim brought by Mr. Richardson in this regard.

SIGNATURES

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.

PALLET MANAGEMENT SYSTEMS, INC.

Dated: May 14, 2002

By: /s/ John C. Lucy III

John C. Lucy III, Chief Executive Officer

Dated: May 14, 2002

By: /s/ Marc S. Steinberg

Marc S. Steinberg, Chief Financial Officer, Vice President, Treasurer and Secretary