PALLET MANAGEMENT SYSTEMS INC
Form 10-K
October 11, 2002

U.S. 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 JUNE 29, 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 or Organization)	(I.R.S. Employer Identification Number)
2855 University Drive, Suite 510 Coral Springs, Florida	33065
(Address of Principal Executive Offices)	(Zip Code)

Registrant's Telephone Number, Including Area Code: (954) 340-1290

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

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, par value $.01 per share

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 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 90 days.

Yes X No ___

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-B 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. [ ]

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant is $ 551,378 based on the closing price of $ 0.23 per share as of September 27, 2002.

As of September 27, 2002, there were 3,996,612 shares of the registrant's common stock outstanding.

Documents Incorporated By Reference:

None.

PALLET MANAGEMENT, INC.
FORM 10-K
FOR THE YEAR ENDED JUNE 30, 2001

TABLE OF CONTENTS

FORWARD-LOOKING STATEMENTS

Pallet Management Systems, Inc. ("Pallet Management," or the "Company") cautions readers that certain important factors may affect Pallet Management's actual results and could cause such results to differ materially from any forward-looking statements which may be deemed to have been made in this Report or which are otherwise made by or on behalf of Pallet Management. For this purpose, any statements contained in this Report that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the generality of the foregoing, words such as "may," "expect," "believe," "anticipate," "intend," "could," "estimate," or "continue" or the negative other variations thereof or comparable terminology are intended to identify forward-looking statements. Pallet Management is also subject to risks detailed in "Risk Factors" (included in Item 6, as well as elsewhere herein) or detailed from time to time in Pallet Management's other filings with the Securities and Exchange Commission.

PART I

ITEM 1. BUSINESS

INTRODUCTION

Pallet Management is the first pallet company in the United States to become publicly traded in the estimated $6 billion pallet industry. The Company is a leader in total solutions for pallet and other transport packaging requirements and offers a wide variety of products and services, from pallet manufacturing, to reverse distribution of transport packaging assets. The primary users of Pallet Management's services are companies from various industries, including steel and metal, chemical and fluid, paper and fiber, furniture, beverage and printing.

The Company is a leader in reducing product distribution costs for major manufacturers and distributors by providing value-added transport packaging products and logistical services. As one of the largest pallet manufacturing companies in the United States, Pallet Management has expanded its line of business to include related transport packaging, logistical and repair services. With two related lines of business, manufacturing and services, Pallet Management primarily manufactures wood pallets, which are the base of most transport packaging assets. Services related to transport packaging, which are focused on reducing customer distribution costs, include transport packaging retrieval, repair, recycling, sorting, warehousing, reverse distribution, tracking, logistics and value-added information services.

A significant portion of Pallet Management's current business is the sale of pallets and services to CHEP, which is part of the international CHEP organization that manages the world's largest pallet rental pool. CHEP service spans 41 countries across six continents controlling more than 180 million pallets and 35 million containers, primarily focused on the retail, grocery and automotive industries.

Pallet Management's business strategy is to manufacture and service pallets as well as other supply chain assets for niche markets. Manufacturing operations complement expansion of the Company's related transport packaging services that should increase gross margins. All of Pallet Management's products and services are designed to assist its customers in reducing the cost per trip for shipments of their goods.

In order to fulfill the increasing demand for transport packaging management services, Pallet Management plans to expand its service offerings and its network of facilities by opening company-owned facilities as well as entering into affiliations with other pallet and logistics companies in strategic locations. These additional locations will provide local retrieval, repair, sortation, storage and recycling services for Pallet Management's national customers. Pallet Management also plans to be able to accelerate its internal growth by marketing expanded value-added information services to new and existing customers using PalletNetTM, its proprietary software application process for the tracking and management of transport packaging assets.

Industry Overview

Pallet Industry

A pallet is a platform, usually made of wood and assembled with metal nails, that is used for storing and shipping goods. Pallets allow goods to be transported or warehoused economically by providing a foundation for forklifts and vertical storage. Pallets are used in virtually all U.S. industries where products are physically distributed, including the automotive, chemical, consumer products, grocery, produce and food production, paper and forest products, retail, and steel and metals industries. Without pallets, shipping by air, land and sea would be severely hampered.

Pallets come in a wide range of shapes and sizes. Although pallets are primarily made of wood, they may also be made from steel, plastic, cardboard, molded wood fiber and other materials to satisfy smaller niche markets. It is estimated by industry sources that there are over seven pallets for each person in the United States, and Pallet Management believes that there are over 1,000 different sizes and specifications of pallets used in North America.

According to a survey conducted in 2001 by the National Wooden Pallet and Container Association ("NWPCA"), 91% of pallet users reported using wood pallets, with just 5% or less using plastic, a combination of wood and plastic, or other material. The wooden pallet has traditionally been the basis for the design of storage racks, warehouse storage areas, forklifts, docks and containers used in shipping goods.

In addition, the grocery industry, which accounts for approximately one-third of the all new pallets produced in the United States, uses a standard size 48 x 40-inch pallet referred to as a GMA pallet. Other industries also utilize unique specifications that are appropriate for their particular needs.

Many pallets are not durable enough for multiple trips. The manufacturing capacity for the standard GMA pallet is in excess of demand and unless one is manufacturing a top quality durable pallet for a customer who wants to use their pallets for multiple trips, the margins are very small. Standard GMA pallets weigh approximately 45 lbs. and are designed to hold 1,500 pounds of goods. Since CHEP has a pool of 48 x 40-inch pallets that are continually reused, it demands a higher quality, better-engineered pallet, which is more durable. A CHEP pallet weighs approximately 60 lbs., and is engineered to hold 2,800 pounds of goods.

Based on information supplied by industry sources, Pallet Management estimates that the U.S. pallet industry currently generates revenues of approximately $6 billion, and it is served by approximately 3,600 companies, most of which are small, privately held entities. These companies are generally operating in only one location and serving customers within a limited geographic region. The industry is generally composed of companies that manufacture new pallets and companies that repair and recycle pallets. The U.S. Forest Service estimated last year that 475 million new wood pallets are produced annually, 300 million wood pallets are repaired and sent back into circulation, and 175 million wood pallets are sent to landfills.

The pallet industry, a generally mature industry, has experienced significant changes during the past several years. These changes are due, among other factors, to the focus by Fortune 1000 businesses on improving the efficiency of their supply chain, manufacturing, and distribution systems. This focus has caused many of these businesses to attempt to reduce significantly the number of vendors serving them in order to simplify their procurement and product distribution processes. It has also prompted large manufacturers and distributors to outsource key elements of those processes that are not within their core competencies and to develop just-in-time procurement, manufacturing, and distribution systems. With the adoption of these systems, expedited product movement has become increasingly important and the demand for a high quality source of pallets has increased. Palletized freight facilitates movement through the supply chain by reducing costly loading and unloading delays at distribution centers and warehouse facilities. As a result, there has been an increased demand for high-quality pallets in an attempt to decrease the cost per trip by reducing product damage during shipping and storage, and increasing the number of trips for which pallets can be used.

The broad changes affecting the U.S. industry have created significant demand for higher quality pallets distributed through an efficient, more sophisticated system. Environmental and cost concerns have also accelerated the trend toward increased reuse or "recycling" of pallets and certain other transport packing materials, further increasing the importance of the quality of newly manufactured pallets.

Due to the high cost of plastics and other materials, wood is the preferred and "more environmentally conscious" material (a renewable resource) for pallets. Wood pallets are also generally stronger, more repairable, and less expensive than comparable plastic pallets. Plastic pallets currently have a limited market in "closed loop" systems where system leakage is minimal and where the pallets can be tracked and retrieved for reuse.

Third-Party Logistics Industry

As manufacturers and retailers continue to drive down the costs of distribution, they will continue to look to third party logistics companies to handle supply chain systems. It is estimated that about 7%, or approximately $40 billion, of relevant logistic costs are currently managed by third party logistics companies. Within the next three to five years, this sector could capture 10% to 15% of the available market. Third party logistics companies include outsourcing companies that manage portions of a company's supply chain. Outsourcing supply chain management gives companies a competitive edge and drives profitability up. The third party logistics industry is expected to experience an annual growth rate of about 20%, driven primarily by the continued outsourcing of specific supply chain logistics functions. Management believes that this industry will eventually be ready for consolidation, as customers will want third-party logistic companies to increase their scope of service offerings on a global level.

"Reverse Distribution" is the opposite of direct distribution; it is moving products back up the supply chain to the original manufacturer. As a sub-industry of the logistics industry, it is estimated to have grown in the United States to over $7.7 billion in 2000 from $4.6 billion in 1997. It is rapidly growing and becoming more diverse and complex as its importance to the supply chain becomes more evident. The increasing importance of Reverse Distribution in the marketplace is a key factor in the dramatic changes taking place in the pallet industry.

Until recently, pallet manufacturers were focused on producing the cheapest pallet for their customers, who considered their packaging material an expense. Manufacturers and distributors are now discovering that the lowest cost per trip (the ultimate goal) for their packaging material is often realized when high quality packaging is utilized and subsequently returned for re-use in a reverse distribution system. Viewing packaging material as an asset instead of an expense requires a reverse distribution system to return packaging assets. Pallet Management is aggressively pursuing this market as a specialist in reverse distribution for reusable transport packaging.

GROWTH STRATEGY

Pallet Management's goal is to become a leading national provider of pallets and related transport packaging services by continuing to expand its existing operations and seeking strategic acquisitions. Pallet Management believes that a significant market opportunity exists for a company that can consistently offer high-quality pallets and related value-added services to large pallet users in the U.S. Pallet Management believes that its management's experience, industry reputation, and existing customer base will provide the Company with a significant competitive advantage as it pursues its growth strategy. Elements of its strategy include:

- CHEP
- Specially Engineered Platforms - Niche Market Manufacturing
- Reverse Distribution Services
- Acquisitions
- Aggressive Marketing

CHEP

CHEP markets to the grocery, retail, and automotive industries, where large volumes of standard size pallets can be contained in a closed loop-system. Based on published information, CHEP has a market share of 88% of all leased pallets worldwide and dominates 90% of the markets in which they operate. They are by far the largest participant in the U.S. pallet industry and do not have a significant pallet-pooling competitor.

They rent high quality, standardized, and easily identifiable (all of their pallets are painted blue) 48" by 40" wooden pallets, primarily for use by grocery and consumer product manufacturers and distributors. CHEP pallets are manufactured to strict specifications by vendors, including Pallet Management, that have been selected based on their ability to provide large volumes of high quality pallets in a timely manner.

The Company entered into a series of multi-year manufacturing agreements with CHEP to produce specially engineered grocery pallets in strategic locations during a period when they experienced significant growth. Pallet Management opened manufacturing facilities in Rogersville, Alabama, in September 1998, Bolingbrook, Illinois, near Chicago, in April 1999, and Plainfield, Indiana, near Indianapolis, in August 1999. Pallet Management has invested over $4.2 million in "state-of the art" pallet manufacturing equipment for these facilities, including a new $1.5 million "Vanderloo" nailing machine system custom made for Pallet Management in Holland and installed at the Company's Plainfield, Indiana facility.

The Alabama and Illinois contracts were completed in September 2001 and April 2002. The Company consolidated most of the equipment into the Indiana facility. The Indiana contract is scheduled to end on March 1st, 2003 and the Company is currently in negotiations to extend this contract. Should the Indiana contract not be extended, the Company may not be able to meet current cash needs and may not be profitable.

In addition to pallet manufacturing, Pallet Management also offers to CHEP Reverse Distribution Services. Pallet Management has a facility which sorts, repairs, warehouses and returns pallets to the CHEP pallet pool.

Pallet Management has had a business relationship with CHEP for over ten years and they are expected to be Pallet Management's largest customer for the next several years, during which Pallet Management will support their continued growth. While Pallet Management is continuously developing this relationship, it is also continuing to aggressively pursue other areas of growth.

Specially Engineered Platforms - Niche Market Manufacturing

Many manufacturers require specially engineered pallets to transport their goods. Pallet Management targets these markets due to the limited number of pallet manufacturers that can produce specialized pallets, the established reputation of Pallet Management in the industry for being a high quality pallet manufacturer, and the higher profit margins realized in the production of these pallets.

Niche market pallets are uniquely engineered to transport a specific product and are not universally used like the standard GMA pallet. Examples of niche pallets Pallet Management builds include those for the metals and fibers industries. These types of pallets are specially engineered by Pallet Management using PDS (Pallet Design System), a system developed by Virginia Tech's Pallet Laboratory in conjunction with the NWPCA.

Most niche market pallets cost more than high volume grocery pallets and yield high margins due to their uniqueness and strict specifications, which are required for automated warehousing operations. Pallet Management is aggressively marketing its experience and expertise in this area, as it believes that large manufacturing companies will always have a demand for specially engineered pallets to transport certain kinds of goods.

Reverse Distribution Services

As large manufacturers have focused more of their attention on reducing distribution costs, Pallet Management has expanded the marketing of its Reverse Distribution services. Reverse Distribution includes the systematic retrieval, sortation, repair, warehouse and return of pallets and other packaging material that creates closed-loop return systems between manufacturers, their customers, and their vendors. Pallet Management's customers own the pallets or containers that are loaded with their products for transport. Large manufacturing companies often make sizable investments in specially engineered and heavy-duty pallets. Pallet Management can recover, sort, repair, warehouse and return a niche pallet to a customer for significantly less than the cost of a new pallet, thereby eliminating or reducing some of its customers' distribution expenses. At the same time, Pallet Management generates greater margins than when a new pallet is built. The key to successfully implementing a large-scale Reverse Distribution program is to have an integrated network that encompasses information, retrieval, and logistics capabilities. Pallet Management is actively seeking strategic relationships to more fully develop its nationwide Reverse Distribution network.

Pallet Management is forming the majority of its Reverse Distribution network through the utilization of the over 3,600 existing pallet manufacturers and recyclers across the United States, as well as creating its own facilities. Many of the smaller pallet companies are looking for an affiliation with a national company as they lack the ability to market their company beyond a limited geographic region, customers demand more diverse geographical services, and CHEP continues to impact the grocery pallet market. Pallet Management believes that many of these companies have excess capacity and are willing to affiliate with Pallet Management on a fee-for-service basis.

During the fiscal year 2000, the Company launched PalletNetTM, a web-based tracking and information system that manages the flow of pallets and other shipping platforms and containers throughout industrial supply chains. As part of the Company's strategy to use the Internet to enhance customer service, PalletNet provides Reverse Distribution information with a single source national contact. This service is supported by leading edge technology that enables users to improve asset control and reduce cost and waste from their supply chain.

PalletNetTM is a browser-based user interface combined with multiple levels of security management, which delivers safe and unlimited access to customers. Customers can view exactly where their shipping platforms and containers are in their supply chain at any given moment. The system, designed to be easily customizable, also offers a full range of personalization options, so each company can configure PalletNetTM to their specific operations. In addition, PalletNetTM has the capacity to use bar codes and integrate radio frequency identification ("RFID") tags to track individual pallets and the equipment transported on them.

These additional services provide the Company's customers the flexibility to meet almost any industrial needs in terms of Reverse Distribution and transport packaging, and an even higher level of customer service and improved supply chain efficiency.

Acquisitions

Pallet Management intends to pursue acquisitions within its existing markets and new markets to increase its market penetration, as well as to

provide a broader range of services to existing customers in those markets. These potential acquisitions will primarily involve transport services businesses and smaller pallet companies whose operations can be incorporated into Pallet Management's existing operations without a significant increase in infrastructure, as well as those that will provide Pallet Management with the ability to service new customers or existing customers in new locations. Pallet Management does not currently plan to acquire any significant additional manufacturing capacity and does not have any current agreements or understandings for any acquisitions. The consideration for such acquisitions, if consummated, could consist of cash, debt, equity or any combination thereof.

CURRENT OPERATIONS

Manufacturing

- High volume, high quality CHEP grocery pallet manufacturing
- Low volume, specially engineered niche pallet manufacturing

Services

- Reverse Distribution services
- Retrieval, Sort, Repair, Warehouse and Return services
- Other Products

Manufacturing. The manufacturing process for new pallets at each of Pallet Management's facilities is generally the most capital intensive part of the business, with the majority of assembly and construction being automated. New pallets are manufactured from an assortment of wood products, varying in type and quality, with construction specifications determined by the pallet's end user. Pallet Management believes that approximately 70% of the wood used in new pallets manufactured in North America consists of hardwood (including oak, poplar, alder and gum), with the balance consisting of pine or other softwoods.

Pallet Management utilizes sawing equipment, which cuts large wood sections to specification. The Company also purchases a vast quantity of pre-cut lumber from outside vendors for pallet manufacturing. The cut wood is then transported to assembly points where employees load the stringers ("runners") or blocks and deck boards into nailing machines that nail the pallets together. A typical nailing machine produces 1,500 - 2,000 pallets per 8-hour shift with three to ten employees. After construction is completed, pallets are prepared for shipment or storage.

All the high volume CHEP pallets and most of the lower volume specially engineered niche pallets are manufactured on automated nailing machines. More customized or smaller niche pallet orders may be manufactured by hand on assembly tables utilizing two laborers with pneumatic nailers. Pallet Management typically manufactures pallets upon receipt of customer orders and does not generally maintain significant finished goods inventory.

Services. Reducing the cost of product distribution in the supply chain is the focus of Pallet Management's value-added services. Retrieval, sortation,

repair, warehouse and return services enable customers to better utilize their packaging assets. Besides being environmentally friendly, a properly repaired used pallet will provide a customer significant savings over having to buy a new pallet.

Pallet Management initiates the retrieval or purchase of used pallets from a variety of sources. The condition and size of these pallets vary greatly. Once obtained, the pallets are sorted by size, condition and potential customer. Pallets that can be repaired have their damaged boards replaced with salvaged boards or boards from new stock inventory 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 goods. Despite recent increases in levels of automation, pallet return operations remain a labor-intensive process.

Other Products and Services. Pallet Management functions as a wholesale distributor of other 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.

MARKETING AND DISTRIBUTION

Pallet Management uses its internal sales force in marketing its products and services. With services being the primary focus of all marketing efforts, Pallet Management seeks to efficiently serve large numbers of customers across diverse markets and industries to provide a stable and diversified base for ongoing sales of services and products.

Pallet Management has many customers that are Fortune 1000 companies, including Honeywell, DuPont, IAMS, Mitsubishi, Owens Corning and Scotts Company, as well as various governmental agencies.

During the fiscal year ended June 29, 2002 CHEP accounted for approximately 86% of Pallet Management's revenues, the same percentage for fiscal year 2001. No other single customer accounted for 10% or more of Pallet Management's revenues. The Company's depot/repair agreement with CHEP is not finalized for fiscal year 2003 and it is anticipated that CHEP will ask that the Company cease doing repair work, which has continued without a contract, at the Petersburg, Virginia location by January 1st, 2003. Manufacturing contracts may be on a multi-year basis and have varying minimum pallet purchase requirements. The CHEP contract prohibits Pallet Management from engaging the corresponding facility to compete with CHEP during the term of the agreement and for up to three years thereafter in the pallet leasing business and from repairing pallets for other pallet leasing companies.

SUPPLIERS

Pallet Management believes that there is an adequate supply of raw material components for pallet production. The primary raw materials are hardwood, softwood, used lumber, used pallets and nails. Pallet Management has several principal suppliers, which are rotated depending on availability. During the fiscal year ended June 29, 2002, Pallet Management purchased lumber and

plywood from over 50 vendors. The three largest suppliers accounted for approximately 18.4%, 17.9% and 8.1 % of the lumber purchases, as compared to 29%, 22% and 5% for fiscal year 2001. During the fiscal year ended June 29, 2002, Pallet Management purchased approximately 4% of its lumber from Clary Lumber Company, Inc., a North Carolina corporation ("Clary"), which is consistent with the 4% from fiscal year 2001, at prices comparable to vendors other than Clary. Clary is owned by John C. Lucy, Jr., a significant shareholder and former Director of Pallet Management, and his son, John C. Lucy III, who is Pallet Management's CEO. See Item 13, "Certain Relationships and Related Transactions." Pallet Management does not believe that the loss of any vendor would materially adversely affect its financial condition or results of operations. Pallet Management intends to continue to pursue a strategy of purchasing from alternative sources of lumber.

Pallet Management's sales prices are closely related to the changing costs and availability of lumber. While Pallet Management believes that it will benefit from strong relationships with multiple lumber suppliers, there can be no assurance that Pallet Management will be able to secure adequate lumber supplies in the future. Lumber supplies and costs are affected by many factors outside Pallet Management's control, including governmental regulation of logging on public lands, lumber agreements between Canada and the U.S., and competition from other industries that use similar grades and types of lumber. In addition, adverse weather conditions may affect Pallet Management's ability to obtain adequate supplies of lumber at a reasonable cost. Though Pallet Management has studied the broad use of alternative materials for the manufacture of pallets, such as plastic, it believes that there is not currently an available alternative raw material that possesses the tensile strength, recyclability and low cost of wood. Pallet Management continues to evaluate alternatives to wood and is receptive to their future use in pallet production.

COMPETITION

Pallet Management believes that the principal competitive factors in the pallet industry are price, product quality, services, and on-time delivery. With over 3,600 industry participants, the pallet manufacturing industry has been and is expected to remain extremely fragmented and highly competitive. While there are several companies that have attempted to establish national pallet operations, most of Pallet Management's competitors are small, privately held companies that operate in only one location and serve customers within a limited geographic region. Pallet Management does not directly compete against many of these companies to a large extent due to its concentration on specialty pallets, which are not made by most of its competitors, although they may at any time attempt to compete directly with Pallet Management. New pallet manufacturers can typically service up to a 300-mile radius, although recyclers typically market within a 100-mile radius. Pallet Management believes that it will have a competitive advantage as it expands its national network of facilities, thus benefiting from economies of scale while interfacing with customers' nationwide distribution systems.

Competition is often intense and Pallet Management faces most of its competition from other manufacturers. Pallet rental systems compete with new pallet sales to the grocery and wholesales distribution industries, and may expand into other industries in the future. Pallet Management does not compete to any significant extent with pallet rental systems in the grocery industry and intends to focus on industries and products in which pallet rental systems are not competitive.

In addition, pallet manufacturing and recycling operations are not highly capital intensive and the barriers to entry in such businesses are minimal. Certain other smaller competitors may have lower overhead costs and,

consequently, may be able to manufacture or recycle pallets at lower costs than Pallet Management. Other companies with significantly greater capital and other resources than Pallet Management may enter or expand their operations in the pallet manufacturing and recycling businesses in the future, changing the competitive dynamics of the industry. While Pallet Management estimates, based on industry sources, that non-wooden pallets currently account for less than 10% of the pallet market, there can be no assurance that Pallet Management will not face increasing competition from pallets fabricated from non-wooden components in the future. Pallet Management does not believe that non-wooden pallets will be widely used until it is demonstrated that they replicate the strength of wood pallets and until their cost decreases from their current levels, which are well above the cost of similar wood pallets.

EMPLOYEES

As of June 29, 2002, Pallet Management had 190 employees. This includes production workers who work on new and recycled pallets, clerical personnel, logistical and computer personnel, facility management personnel, regional management personnel, sales force, customer service personnel, administrative personnel, and executive personnel.

ITEM 2. PROPERTIES

Current Manufacturing and Repair Facilities: Pallet Management currently operates 3 facilities in 2 states:

Plainfield, Indiana - Manufacturing Plant: This facility opened at 6030 Gateway Dr., Plainfield, Indiana, in August 1999 in a 130,000-sq.-ft. facility with a 5-year lease ending September 2004. As of June 29, 2002 there were 52 people employed at this facility, which manufactures wooden pallets on high-speed automated manufacturing lines.

Lawrenceville, Virginia - Manufacturing Plant: Located at 10324 Liberty Road, Lawrenceville, Virginia, new pallet manufacturing is performed at this Company-owned facility using automated equipment. This facility's primary production is specifically engineered niche pallets and cutting lumber to size for pallet production at this facility and shipment to other company facilities. In addition, pallet recycling and repair services are performed at this location, which has 60,000 sq. ft. of manufacturing buildings located on 70 acres, a 3,000-sq.-ft. office building and employed 100 people as of June 29, 2002.

Petersburg, Virginia - Repair Depot: Located at 1925 Puddledock Road, Petersburg, Virginia, this facility processes, repairs, and stores all types of pallets. It contains a 40,000-sq.-ft. warehouse on eight acres owned by the Company. As of June 29, 2002 there were 23 people employed at this facility, which contains "state of the art" automated sorting and repair equipment.

Corporate and Regional Offices: Corporate and regional offices are located at the following addresses:

2855 University Blvd, Suite 510, Coral Springs, Florida - Corporate Headquarters - Five year lease expiring in October 2005.

2900 Highwoods Blvd., Suite 200, Raleigh, North Carolina - Regional Offices - Three year lease expiring September 2002. This lease was extended by one year until August 31, 2003.

Former Facilities:

Bolingbrook, Illinois - Manufacturing Plant: This facility opened in April 1999 at 335 Crossroads Suite B, Bolingbrook, Illinois in a 110,000-sq.-ft. facility. The lease was terminated in August 2002 based on a negotiated buyout of the remaining lease payments for $25,000. The facility employed no people as of June 29, 2002.

Rogersville, Alabama - Manufacturing Plant: Located at 120 Industrial Park Road, Rogersville, Alabama, this facility opened in September 1998 in a 25,500-sq.-ft. facility. The Company closed this facility in March 2002.

ITEM 3. LEGAL PROCEEDINGS

The Company's Board of Directors terminated the employment of Mr. Zachary Richardson as President of the Company effective March 15, 2002. Mr. Richardson ceased acting on behalf of the Company on January 23, 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 settled with Mr. Richardson for approximately $54,000 in July 2002.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On May 13, 2002 the Company held its annual meeting of shareholders. At the meeting the Company's shareholders:

(a) elected six of the seven director nominees (David Davidson, the other nominee, withdrew his name from consideration a few days prior to the meeting and the Board of Directors did not designate a substitute director nominee in his place);

(b) did not approve the proposed amendments to the Company's 1998 Omnibus Stock Option Plan by a vote of 824,643 for, 703,512 against and 16,235 abstaining; and

(c) ratified the appointment of Kaufman, Rossin and Co. as the independent auditors by a vote of 3,598,847 for, 5,500 against and 20,935 abstaining.

The following individuals were elected to the Company's Board of Directors for a one-year term by the votes indicated:

Name	Votes For	Authority Withheld
Ira M. Goldberg	3,613,582	10,800
Michael D. Karsch	3,614,382	10,000
Richard J. Katz	3,614,382	10,000
Ronald Shindler	3,610,632	13,750
Alan P. Sklar	3,613,582	10,000
Robert Steiler	3,610,632	13,750

Mr. Shindler resigned from the Board on July 11, 2002, because of his election to the management committee of the law firm in which he is a partner, which will require a greater time commitment from him. The remaining Directors elected Mr. Steiler as Chairman at that time.

PART II

ITEM 5. MARKET FOR REGISTRANTS COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Pallet Management's Common Stock is quoted on the OTC Bulletin Board(R) under the symbol PALT. The following table sets forth the average of the high and low bid prices of Pallet Management's Common Stock as reported on the OTC Bulletin Board(R) for each quarter from June 25, 2000 through June 29, 2002. The quotations in the following table represent prices between dealers and do not include retail markup, markdown, or commissions paid and may not represent actual transactions. Such quotations are not necessarily representative of actual transactions or of the value of the Company's securities.

FISCAL 2002		
July 1, 2001 through September 29, 2001	$1.40	$0.73
September 30, 2001 through December 29, 2001	$1.75	$0.35
December 30, 2001 through March 30, 2002	$1.35	$0.35
March 31, 2002 through June 29, 2002	$0.75	$0.22
FISCAL 2001		
June 25, 2000 through September 30, 2000	$3.875	$2.0625
October 1, 2000 through December 30, 2000	$3.0625	$1.375
December 31, 2000 through March 31, 2001	$3.09375	$1.50
April 1, 2001 through June 30, 2001	$1.70	$1.02

As of September 27, 2002, there were 74 holders of record of the Company's Common Stock.

DIVIDEND POLICY

Pallet Management has not paid any cash dividends on its Common Stock since its inception. Pallet Management presently intends to retain future earnings, if any, to finance the expansion of its business and does not anticipate that any cash dividends will be paid in the foreseeable future. Future dividend policy will depend on Pallet Management's earnings, capital requirements, expansion plans, financial condition and other relevant factors.

RECENT SALES OF UNREGISTERED SECURITIES

None.

13

SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted - average exercise price of outstanding options, warrants and rights	Num remai futu equity (exc refle
	(a)	(b)	

Equity compensation plans approved by security holders	1,767,505	$ 1.93
Equity compensation plans not approved by security holders	--	$ --
Total	1,767,505	$ 1.93

ITEM 6. SELECTED FINANCIAL DATA

	Fiscal Year		
	29-Jun-02	30-Jun-01	24-Jun
Net Sales	$ 47,799,439	$ 72,167,233	$ 62,445
Income (loss) from continuing operations	$ (1,144,424)	$ 302,984	$ (2,249
Income (loss) from continuing operations per share	$ (0.28)	$ 0.07	$ (
Total Assets	$ 9,895,246	$ 12,879,737	$ 13,350
Long-term debt	$ 286,393	$ 5,576,663	$ 5,597
Cash dividends per share	$ --	$ --	$

14

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

Fifty-third Week in Fiscal Year 2001

Comparisons of fiscal year 2002 to fiscal year 2001 are affected by an additional week of results in fiscal 2001. Because our fiscal year ends on the last Saturday in June, a fifty-third week is added every 5 or 6 years. The fifty-third week increased 2001 net sales by an estimated $1.3 million and net income by an estimated $6 thousand.

Cautionary Statements

The following discussion and analysis should be read in conjunction with Pallet Management's Consolidated Financial Statements and the Notes thereto included in Part II, Item 8 of this Report.

The following discussion regarding Pallet Management and its business and operations contains "forward-looking statements" within the meaning of Private Securities Litigation Reform Act 1995. These statements consist of any statements 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 a key customer, competition, risks related to acquisitions, difficulties in managing growth, dependence on key personnel and other risk factors discussed in this report. See "Risk Factors." 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 the Pallet Management over time means that actual events are bearing out as estimated in such forward looking statements.

RESULTS OF OPERATIONS

General

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 huge service-orientated market for the Company.

With this shift in focus toward services and cost efficiency, we are offering "state of the art" logistical services known as "Reverse Distribution". Reverse Distribution involves 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 Distribution system also has environmental benefits.

As this market of Reverse Distribution is just starting to be created, the economic advantages to companies that are implementing it are huge. We are working diligently as an industry leader in this area, as the growth potential continues to unfold.

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 a contract to manufacture high quality grocery pallets for CHEP, the world's largest pallet rental pool. The Company has one manufacturing facility currently producing CHEP pallets.

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; 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.

Companies currently discard a large portion of new pallets after one use. The condition and size of these pallets vary greatly. The pallets are retrieved, 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 control and reduce cost and waste from the supply chain, while also 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 a browser-based user interface combined with three levels of security management which delivers unlimited, safe access to customers who can view exactly where their shipping platforms and containers are in the supply chain at any given moment. The system is also designed to be easily customizable, so each company can configure PalletNetTM to their specific operations. In addition, PalletNetTM has the capacity to use either bar codes or radio frequency identification (RFID) tags to track individual pallets and the equipment transported on them. These new, "state of the art" tracking, logistics and information system capabilities provide customers and Pallet Management the technical support needed to manage an efficient Reverse Distribution operation and valuable transport packaging from any location where Internet access is available.

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 we progress in our marketing and sales effort within this area.

Discussion of fiscal year 2002

Fiscal year 2002 saw many changes within our Company. Two manufacturing contracts with our largest customer in Alabama and Illinois were not renewed. Compared to fiscal year 2001, the impact of those two contracts within the fiscal year was a reduction in revenue of $20.4 million. The equipment for both of those facilities was moved primarily to our Indiana facility to increase that plant's production capacity for CHEP or other customers. Additionally, the decline in business experienced by our Lawrenceville, Virginia facility, which began in January 2001, continued until February 2002. That decline was caused primarily by general economic conditions and negatively impacted sales during fiscal year 2002 as compared with fiscal year 2001 by $3.4 million.

During March, the Company terminated its President, who, pursuant to the request of the Company's Board of Directors, had relinquished executive authority on behalf of the Company on January 23, 2002. The Company's Board of Directors at that time appointed Robert Steiler, one of its members, to be the Company's interim leader of its executive management . Numerous cost cutting measures were implemented, and the Company reduced expenditures by over $1,000,000 annually. The Company began an aggressive marketing campaign in March 2002, including a new brochure, media advertising and other marketing materials, and began a direct mail campaign offering incentives to win new customers and bring others more strongly into the fold.

As the fiscal year came to a close we experienced a continued increase in the order rate into our Virginia facility, as well as strong orders from our largest customer for our Indiana facility

17

Our current management team continues to recognize the dependency on a single customer and is taking steps to expand our customer base for niche pallets and PalletNetTM services. We are continuing with an aggressive marketing campaign and are beginning implementation of our PalletNetTM Asset Tracking System.

June 29, 2002 vs. June 30, 2001

For the year ended June 29, 2002, net sales decreased 34% to $47,799,439 from $72,167,233 for the prior year. This decrease was due mainly to the closings of the Alabama and Illinois facilities, which serviced one main customer. The decrease in sales from these two facilities were $20.4 million in fiscal 2002 as compared with fiscal 2001. Additionally, the decline in business experienced by our Lawrenceville, Virginia facility, which began in January 2001 continued until February 2002. That decline was caused primarily by soft general economic conditions and negatively impacted sales during fiscal year 2002 as compared with fiscal year 2001 by $3.4 million. Sales other than new pallet sales, comprised principally of service, accounted for 3% of net revenues, as opposed to 4% of net revenues the previous year. These sales dropped from approximately $2,047,000 in fiscal year 2001 to approximately $1,887,000 in fiscal year 2001. The decrease is primarily due to a slightly reduced demand from that facility's main customer.

Cost of sales for 2002 was $44,810,597 or 93.7% of net sales, as compared to $67,035,408 or 92.9% of net sales for 2001. This increase in cost of sales in relation to net sales, is primarily due to the mix in sales and still reflects the more efficient operations that were achieved in production throughout fiscal year 2001. In addition, we continued to focus on cost control as production slowed in two facilities (Alabama in the beginning of the fiscal year and Illinois at the beginning of the third fiscal quarter) and reduced spending. Efficiencies were maintained in the plants by controlling machine down time and improved production planning during periods of reduced demand.

Selling, general and administrative expenses were $3,681,120 or 7.7% of net sales in 2002, as compared to $4,320,719 or 6.0% of net sales in 2001. This increase is primarily due to decreased sales volume in Alabama and Illinois with a lag in corresponding decreases in costs. Reductions were made in many areas including travel, entertainment, legal and salaries to offset the decrease in revenues, however, we incurred runoff expenses as these operations wound down inclusive of salaries, severance payments and rent/utilities without production and sales. Additionally, the Company has not put its nailing machine from the Alabama facility into service since the latter plant's closure. The nailing machine has not been used in over 12 months and is sitting idle in the Company's Indiana facility. The Company took an impairment write down of $154,740 on this machine as of June 29, 2002. Customers are still being sought for production utilizing this machine, but it appeared unlikely that the asset costs would have been recovered at its then net book value and therefore, the write down was required. Our corporate structure during the year became more streamlined as we reduced headcount to offset the decreased revenues associated with these plant closings.

Net interest expense decreased to $379,864 in 2002 from $528,078 in 2001. This decrease came as a result of both reductions to the prime interest rate and reductions in our loan amounts. We no longer borrowed against inventories in Alabama and Illinois (plant closings), which reduced our average debt. Additionally, a tight focus on cash management allowed the Company to reduce its net borrowings on an ongoing basis.

Net losses for 2002 were $1,144,424 compared to a net income of $302,984 in 2001. This difference of over $1.4 million is primarily due to reductions in sales from our Alabama and Illinois plants which closed during fiscal year 2002. The reduction in gross sales from those two facilities totaled $20.4 million. The Company also saw declining sales out of the Lawrenceville, Virginia facility by $3.4 million from the prior year due to poor economic conditions. The Company reacted to the facility closures by reducing costs in the second half of the year. The impact of those reductions will not be felt until fiscal year 2003 due to the timing of those reductions as some included run-off costs through May and June (severance payments, rent, and contractual obligations).

June 30, 2001 vs. June 24, 2000

For the year ended June 30, 2001, net sales increased 16% to $72,167,233 from $62,445,175 for the prior year. This increase was due mainly to an increase in new pallet sales, which accounted for 97% of net revenues, as opposed to 92% of net revenues the previous year. New pallet sales increased due to sales to one customer, which accounted for 86% of our sales. Sales other than new pallet sales, comprised principally of service, accounted for 3% of net revenues, as opposed to 8% of net revenues the previous year. These sales dropped from approximately $4,996,000 in fiscal year 2000 to approximately $2,047,000 in fiscal year 2001. The decrease is a result of closing the Lakeland facility in fiscal year 2000, and a reduction in the order rate on services experienced in our third quarter.

Cost of sales for 2001 was $67,035,408 or 93% of net sales, as compared to $59,097,842 or 95% of net sales for 2000. This decrease in cost of sales in relation to net sales, is due to becoming more efficient in production throughout fiscal year 2001. In addition, we focused on cost control and reduced spending. Efficiencies were gained in the plants by reducing machine down time and by planning production during periods of reduced demand. By leveling our production, we held down additional costs in our facilities and contributed to the cost of sales percent decrease noted above. By decreasing down time, we were able to produce more product without adding additional labor costs, which also reduced our cost per unit.

Selling, general and administrative expenses were $4,320,719 or 6.0% of net sales in 2001, as compared to $4,899,091 or 7.8% of net sales in 2000. This decrease is primarily due to increased sales volume and cost control. Reductions were made in many areas including travel, entertainment and legal expenses and salaries. Our corporate structure during the year became more streamlined as we set our management team in place and focused on putting controls in place while developing new sales opportunities.

Net interest expense decreased to $528,078 in 2001 from $545,119 in 2000. This decrease came as a result of improved cash management. We changed our approach on borrowing from our revolver loan to reduce the average outstanding balance on a daily basis. We borrowed $1,031,000 in fiscal year 2001 for our new Vanderloo nailing machine, which was installed in our Plainfield, Indiana facility. By increasing our borrowings, we incurred more interest expense, which offset the savings realized from our improved cash management policies and procedures. Additionally, we were helped during the year by declining interest rates that contributed to reduce expenses.

19

Net income for 2001 was $302,984 compared to a net loss of $2,249,967 in 2000. This was an improvement of over $2.5 million and signified a turnaround to profitability. During 2001 manufacturing operations made many improvements which led to our profitable year. Among those improvements were significant reductions to machine downtime, process engineering to eliminate costs from our manufacturing lines and reductions in staffing where appropriate. During November we began planning for a slow down from our major customer in January. We were prepared for and minimized losses during a slow third quarter and when sales started coming back up in April, we were prepared to meet all of our customer expectations.

The month of May saw the largest increase to pine lumber prices in recent history of nearly 30% and contributed greatly to losses during that month as we could not pass this cost increase on to our customers. We continued to meet our customer demands and worked with our vendors on gaining price reductions to counteract the May pine lumber price increases seen in May so that our profitability for June would be maximized. During the course of this fiscal year, we reorganized the business structure of the company by creating distinct departments, which had clear lines of responsibility and authority. We also hired a completely new senior management team. During the transition of reorganizing, we relied upon outside consultants to fill some senior management positions until the new management team was in place. Consultants were utilized primarily for manufacturing operations, human resources, marketing, materials, systems and logistics. The company expects to reduce expenditures on consultants materially during fiscal year 2002. The total expenditures made during the course of fiscal year 2001 for these consultants were $515,000.

Liquidity and Capital Resources

We had $72,561 of cash on hand at June 29, 2002, compared to $232,635 at the beginning of fiscal year 2002. Net cash provided from operating activities was $845,014 for the year. We decreased our account receivables by approximately $1,086,000 and our inventories by approximately $943,000 during the fiscal year. The account receivables decreased as a result of improved collections, and the reduction of sales due to two plant closings in fiscal year ending June 2002. The inventories were reduced primarily due to the two plant closings and the effort to reduce our on-hand balances and increase our turns to generate effective uses of cash.

Our debt servicing with LaSalle Business Credit, Inc. remained consistent with prior years. We both reduced our loan principal with timely payments and continued to reduce our revolving loan down. We decreased our borrowings from LaSalle Business Credit, Inc. by $ 799,500 during the fiscal year ended June 29, 2002. This decrease was made up of a reduced revolver borrowing base (plant closings) of $211,500 plus principal payments on our term and real estate loans of $588,000.

In the first, third and fourth quarters of fiscal 2002, the Company did not meet its covenants with LaSalle Business Credit, Inc. Although LaSalle Business Credit, Inc., gave us waivers, it also increased our borrowing interest rate to prime plus 2%. Due to the Company's performance in the fourth quarter of fiscal 2002, it is likely that the reset covenants would be met by the end of the first quarter in fiscal 2003. The Company is working with LaSalle Business Credit, Inc., to adjust the covenants; however, it can not be ascertained how LaSalle Business Credit, Inc. will react covenant violations in the future.

Pallet Management intends to pursue expansion and acquisition plans, which may include the opening of additional facilities as well as the acquisition of additional facilities or companies. The success and timing of any such plans and required capital expenditures for them cannot be reasonably estimated at this time and the Company has no current arrangements with respect to any such acquisition or expansion. Funding for these plans and for ongoing operations could be a combination of issuance of additional equity, working capital, additional borrowings, and profits from operations. Pallet Management cannot make any assurances that such funding would become available for such plans.

Management believes that existing cash on hand, cash provided by future operations and services, additional borrowings under its current line of credit, and a negative net working capital of $2,636,000 as of June 29, 2002, may not be sufficient to finance its operations, expected working capital and capital expenditure requirements for the next twelve months. To have sufficient capital, an increase in the order rate in the Lawrenceville, Virginia operation needs to occur at a level twice that experienced in fiscal 2002, and continued, consistent ordering, with or without a contract renewal/extension with CHEP, needs to happen from them. If this does not occur, the Company may not be able to meet its obligations without additional financing during fiscal year 2003.

RISK FACTORS

LIMITED HISTORY OF PROFITABLE OPERATIONS

The Company reported a net loss of $1,144,424 for the fiscal year ended June 29, 2002, a net income of $302,984 for the fiscal year ended June 30, 2001, a net loss of $2,249,967 for the fiscal year ended June 24, 2000, a net income of $537,529 for the fiscal year ended June 26, 1999, and a net income of $191,627 for the fiscal year ended June 27, 1998. The Company cannot guarantee that it will be profitable or that it will sustain growth. The Company cannot guarantee that it will sustain or increase profitability on a quarterly or annual basis in the future.

DEPENDENCE ON KEY CUSTOMER

The Company currently depends on CHEP for a material portion of its business. During the fiscal year ended June 29, 2002 and for the fiscal year ended June 30, 2001, approximately 86% of the Company's revenues and a significant percentage of its growth were attributable to CHEP. The Company expects that the revenues from CHEP may account for up to 80% of its revenues and will continue to be a material portion of its business for the next fiscal year until the Company can diversify its customer base. In addition, CHEP is the predominant customer of certain of the Company's facilities. If CHEP were to materially decrease its purchase of pallets from the Company, the Company's financial condition and results of operations would be materially adversely affected. The Company has an agreement with CHEP for its Plainfield, Indiana facility to perform CHEP pallet manufacturing. The repair and depot services provided out of the Petersburg, Virginia facility are not under contract and could end with 120 day notice, although this would not significantly impact the profitability of the Company. The Company has been notified by CHEP that the existing Indiana agreement will not be renewed on March 1, 2003. The Company is currently negotiating a new agreement for its Plainfield, Indiana location, but can not guarantee that this contract will be concluded prior to the expiration of the original contract.

SUPPLY AND DEMAND FOR LUMBER

Pallet prices are closely related to the market price of lumber, the principal raw material used in the manufacture and repair of wooden pallets. If lumber prices increase sharply, the Company may not be able to pass this increase on to its customers. The Company has attempted to index the sale prices of its pallets based on its lumber costs, although the Company has not always been able to do so.

The price of lumber has been volatile in recent years due to factors beyond the Company's control, including:

- weather and other natural events;
- governmental regulation of logging on public lands;
- lumber agreements between Canada and the U.S.; and
- competition from other industries that use similar grades and types of lumber.

Although the Company typically buys its lumber in the open market, the Company purchased approximately 44% of its lumber from 3 suppliers in fiscal 2002. However, the Company might be unable to purchase adequate lumber supplies to meet its needs. To the extent the Company encounters adverse lumber prices or is unable to procure adequate supplies of lumber, the Company's financial condition and results of operations could be materially adversely affected. The Company purchased approximately 4.2% of its lumber from a related company, Clary Lumber Company, Inc., a North Carolina corporation. See Item 13, "Certain Relationships and Related Transactions."

COMPETITION FROM OTHER COMPANIES

There are over 3,600 companies that manufacture pallets or provide pallet recycling services. Many of these are small companies that concentrate on the grocery and retail businesses in which the Company does not generally compete, although they might at any time attempt to compete directly with the Company. The Company generally services specialty markets and other services in which there are not as many competitors. CHEP's pallet rental system competes with new pallet sales to the grocery and wholesale distribution industries, and may expand into other industries in the future.

Pallet manufacturing and recycling operations are not highly capital intensive, and the barriers to entry in these businesses are minimal. Smaller competitors might have lower overhead costs and consequently, may be able to manufacture or recycle pallets at lower costs than the Company. Other companies with significantly greater capital and other resources than the Company (including CHEP) might enter or expand their operations in the pallet manufacturing and recycling businesses in the future, which could change the competitive dynamics of the industry.

POTENTIAL INCREASE IN DEBT AND INTEREST EXPENSE AND FINANCING

On March 31, 2000, the Company established a $9,609,000 borrowing facility with LaSalle Business Credit, Inc., of which approximately $4,880,000 was outstanding as of June 29, 2002.

The Company uses the borrowing facility to finance receivables, inventory, and real estate as well as for various other corporate purposes including the purchase of new equipment. Thus, the Company's debt and interest expense may be substantially higher in the future, which could limit the Company's flexibility. In addition, this bank has a lien on substantially all of the Company's assets.

During fiscal year 2002, the Company did not pass the Consolidated Debt Service Coverage Ratio for the thirteen weeks ending September 29, 2001, the Company did not pass the Consolidated Tangible Net Worth, the Consolidated Interest Coverage Ratio or the Consolidated Debt Service Coverage Ratio for the thirty-nine week period ending March 30, 2002 and the Company did not pass the Tangible Net Worth covenant for the period ending June 29, 2002. The Company has received waivers for these covenant violations. LaSalle Business Credit raised our interest rate to prime plus 2% on all of our outstanding loans when the waivers were granted.

Should the Company not meet its reset covenants for fiscal 2003, LaSalle Business Credit may not renew our loan which comes due in October, 2003 and could seek liquidation of our assets to satisfy our loan if we are unable to secure new financing. If interest rates were raised by 100 basis points, given our outstanding debt, the additional interest expense would be approximately $50,000

POTENTIAL RISKS RELATED TO ACQUISITIONS

One of the Company's growth strategies is to acquire additional pallet manufacturing and recycling companies to increase the Company's revenues and markets. Acquisitions involve a number of risks, including:

- adverse short-term effects on the Company's operating results;
- difficulties in successfully integrating and managing additional businesses;
- diversion of management's attention;
- dependence on retention, hiring and training of key personnel;
- loss of existing or anticipated customers of the acquired

companies;
- o unanticipated problems or legal liabilities; and
- o amortization of acquired intangible assets.

Some or all of these risks could have a material adverse effect on the Company's financial condition or results of operations. In addition, to the extent that consolidation becomes more prevalent in the industry, the prices for attractive acquisition candidates might increase and the number of attractive acquisition candidates might decrease. The Company cannot guarantee that it will be able to acquire additional businesses or successfully integrate and manage such additional businesses.

POTENTIAL PROBLEMS IN FINANCING ACQUISITIONS

The Company might potentially issue additional shares of its Common Stock as partial consideration for future acquisitions. If the Common Stock does not maintain a sufficient valuation or potential acquisition candidates are unwilling to accept Common Stock as part of the consideration for the sale of their businesses, the Company might be required to use more cash or bank financing, if available, in order to complete acquisitions. If the Company does not have sufficient cash resources or borrowing availability, the Company's growth could be limited unless the Company is able to obtain additional capital through future debt or equity financing. The Company does not currently have sufficient availability under its current facility to finance any additional acquisitions. Using cash to complete acquisitions and finance internal growth could substantially limit the Company's financial flexibility. Using debt could result in financial covenants that limit the Company's operations and financial flexibility. The Company might be unable to obtain financing if and when needed on acceptable terms. As a result, the Company might be unable to pursue its acquisition strategy successfully.

TRANSACTIONS WITH AFFILIATES

For fiscal 2002, the Company purchased approximately $1,539,000 or 4%, as compared to $2,455,000 or 4% for fiscal 2001, of its lumber supply from Clary Lumber Company, Inc., a North Carolina corporation ("Clary"), which is owned by the family of John C. Lucy, Jr., a principal shareholder and former Director of Pallet Management. John C. Lucy, III, Mr. Lucy's son, is Pallet Management's Chief Executive Officer and is also President and a minority shareholder of Clary. The Company closely monitors these transactions and believes that these transactions were, and are, made at prices comparable to vendors other than Clary in the ordinary course of business.

VOLATILITY OF STOCK PRICE

The trading price of the Company's Common Stock has been, and in the future is expected to be, volatile. The Company may experience further market fluctuations as a result of a number of factors, including:

- o current and anticipated results of operations;
- o changes in the Company's business, operations or financial results;
- o general market and economic conditions;
- o competition;
- o the low number of shares outstanding;
- o low trading volume;
- o the number of market makers in the Company's stock; and

- other factors.

DIFFICULTIES IN OBTAINING NEW SALES

In the last year, the Company has brought in key personnel to sustain current sales and focus on new sales. New sales will be required to sustain current operations in all of our facilities. Should the Company not be able to obtain adequate new sales we might be unable to:

- successfully implement its business and marketing strategy;
- generate sufficient cash flow from operations;
- manage its costs; and
- successfully manage continued growth.

The failure to obtain new sales might have a material adverse effect on the Company's business, financial condition and results of operations.

DEPENDENCE ON KEY PERSONNEL

The Company materially depends upon the services of the following individuals:

- John C. Lucy, III, Chief Executive Officer
- Marc Steinberg, Chief Financial Officer, Secretary and Treasurer
- Ellen Chambers, Director of Information Technologies

The Company has a five-year employment agreement with Mr. Lucy that expires October 2003. In addition, the Company currently has Key-man insurance in the amount of $1,000,000 on Mr. Lucy. The Company would be adversely affected by the loss of the services of any of the above-mentioned individuals.

NO DIVIDEND PAYMENTS

The Company has never paid any cash dividends on its Common Stock and does not anticipate paying cash dividends on its Common Stock in the foreseeable future. The future payment of dividends is directly dependent upon the Company's future earnings, capital requirements, financial requirements and other factors to be determined by the Company's Board of Directors. For the foreseeable future, it is anticipated that earnings, if any, which may be generated from the Company's operations will be used to finance the Company's growth.

VULNERABLE STOCK PRICE

If the Company's stockholders sell substantial amounts of their Common Stock (including shares issued upon the exercise of outstanding options), the market price of the Company's Common Stock could fall. As of September 27, 2002 the Company had outstanding 3,996,612 shares of Common Stock, of which 3,177,353 shares are freely tradable in the public market, and of which 819,259 shares are "restricted securities" under the Securities Act of 1933, as amended (the "Securities Act"). The Company's officers, directors and employees own options to purchase up to 1,158,149 additional shares of Common Stock.

Restricted securities may only be sold pursuant to an effective registration statement under the Securities Act or in compliance with Rule 144 under the Securities Act or other exemption from registration. Rule 144 provides that a person holding restricted securities for a period of one year may sell such securities during any three-month period, subject to certain exceptions, in limited amounts. Rule 144 also permits, under certain circumstances, the sale of shares without any quantity limitations by a person who is not our affiliate and who has held the shares for a two year holding period. No predictions can be made as to the effect, if any, that market sales of such shares or the availability of such shares for future sale will have on the market price of the Common Stock prevailing from time to time.

POTENTIAL ISSUANCE OF PREFERRED STOCK

The Company's Articles of Incorporation authorize 7,500,000 shares of preferred stock, none of which are issued and outstanding as of the date hereof. As provided in the Company's Articles of Incorporation, preferred stock may be issued by resolutions of the Company's Board of Directors from time to time without any action of the stockholders. These resolutions may authorize issuance of the preferred stock and set dividend and liquidation preferences, voting rights, conversion privileges, redemption terms and other privileges and rights. Accordingly, the Company's Board of Directors may, without stockholder approval, issue preferred stock with dividend, liquidation, conversion, voting or other rights which could adversely affect the voting power or the rights of the holders of the Company's Common Stock. The preferred stock could be utilized, under certain circumstances, as a method of discouraging, delaying or preventing a change in control of Pallet Management.

ANTITAKEOVER EFFECTS IN OUR CHARTER DOCUMENTS AND UNDER FLORIDA LAW

Certain provisions of our Articles and Bylaws may be deemed to have antitakeover effects and may delay, defer or prevent a hostile takeover, including prohibition of shareholder action by written consent and advance notice requirements for shareholder proposals and director nominations In addition, Florida has enacted legislation that may deter or hinder takeovers of Florida corporations. The Florida Control Share Act generally provides that shares acquired in excess of certain specified thresholds will not have any voting rights unless such voting rights are approved by a majority of the corporation's disinterested shareholders. The Florida Affiliated Transactions Act generally requires supermajority approval by disinterested shareholders of certain specified transactions between a public corporation and holders of more than 10% of the outstanding voting shares of the corporation (or their affiliates).

CRITICAL ACCOUNTING POLICIES

ESTIMATES

In preparing financial statements in accordance with accounting principles generally accepted in the United States of America, management makes estimates and assumptions that affect the reported amounts and disclosures of assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The Company has recorded deferred tax assets of approximately $1,721,000 and $1,297,689 at June 29, 2002 and June 30, 2001, respectively, which are completely offset by valuation allowances. Realization of the deferred tax asset is dependent on generating sufficient taxable income in the future. The amount of the deferred tax asset considered realizable could change in the near term if estimates of future taxable income are modified.

STOCK OPTIONS (SFAS 123)

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 (SFAS 123), 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.

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" (SFAS 143), 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.

Management believes adoption of these statements will not have a material effect on the financial statements of the Company.

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" (SFAS 144), effective for fiscal years beginning after December 15, 2001 with earlier application encouraged. This statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. The Company adopted SFAS 144 during the current year, which did not have a material impact on the Company's financial statements. However, the Company did recognize an impairment loss on certain long-lived assets as discussed in Note D.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statement No's. 4, 44, and 64, Amendment of FASB Statement No. 13 and Technical Corrections" (SFAS 145). This statement, among other things, eliminates an inconsistency between required accounting for certain sale-leaseback transactions and provides for other technical corrections. Management believes adoption of this statement will not have a material effect on the financial statements of the Company.

27

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" (SFAS 146). This statement addresses accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force Issue No. 94-3. The statement is effective for exit or disposal costs initiated after December 31, 2002, with early application encouraged. The Company has not yet adopted this statement, and management has not determined the impact of this statement on the financial statements of the Company.

Refer to "Notes to Consolidated Financial Statements" in "Note A - Summary of Significant Accounting Policies" as part of the Financial Statements attached for other accounting policy discussions.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

None.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements are attached at the end of this document.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

28

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF REGISTRANT

The following table sets forth the names, ages and positions held with respect to each Director and Executive Officer of the Company.

Name	Age	Position
Robert L. Steiler	54	Interim President and Chairman of the Board of Directors
John C. Lucy, III	43	Chief Executive Officer
Marc S. Steinberg	40	Chief Financial Officer and Vice President
Ira M. Goldberg	46	Director

Michael D. Karsch	42	Director
Richard J. Katz	70	Director
Alan P. Sklar	63	Director

DIRECTORS AND OFFICERS

Robert L. Steiler was elected as the Interim President of the Company on March 15, 2002, and a Director of the Company in April 2000. On July 11, 2002, Mr. Steiler became the Chairman of the Board of Directors. He has been a principal of Lewis Management Group, a consulting firm specializing in business strategy, business development, manufacturing operations and logistics, since its founding in 1990. Mr. Steiler's firm has served as a manufacturing consultant to the Company since his election to the Board. See "Certain Relationships and Related Transactions." Prior to founding the Lewis Management Group, Mr. Steiler was associated with KPMG Peat Marwick from 1988 to 1990. Earlier in his career he was Vice President of Materials with Great Atlantic and Pacific Tea Company, where he directed the material management functions and a highly sophisticated computer-controlled picking and storage system. He was also Vice President of Materials for SmithKline Beecham, a Fortune 100 pharmaceutical company. Mr. Steiler graduated from St. John's University with an MBA in Management.

John C. Lucy, III, has served as Chief Executive Officer of the Company since 1995. In addition to being CEO of the Company, he is President of Clary Lumber, a hardwood lumber sawmill located in Gaston, North Carolina. (see "Certain Relationships and Related Transactions"), and is also Vice-President of Blacksburg Enterprises, Inc., which operates a food service franchise in

Blacksburg, Virginia. From 1995 through 1999, Mr. Lucy served the Company as both CEO and Chairman of the Board. Mr. Lucy has also been actively involved in the NWPCA, where he served for two years as Chairman of the Military Packing Task Force, and for three years as Chairman of the Research Steering Committee. Mr. Lucy graduated from Virginia Tech with a B.S. degree in business.

Marc S. Steinberg joined the Company in July 2000 as its Corporate Controller and became the Chief Financial Officer and Vice President in January 2002. Mr. Steinberg was also appointed Treasurer and Secretary effective August 2000. Mr. Steinberg has worked in the field of accounting for the past 18 years, and has extensive experience in the manufacturing industry. Prior to joining the Company, Mr. Steinberg served as the controller for the transportation and education subsidiaries of TFG Corporation. Prior to that, Mr. Steinberg served as the controller of RTP Corp. (an electronics equipment manufacturer), controller for Mederer Corporation (a candy manufacturer), and cost accounting manager for Sensormatic Electronics Corp. (an electronics equipment manufacturer). Mr. Steinberg has a CPA license, a CMA license and is certified in Production and Inventory Management. Mr. Steinberg graduated from the University of Florida in 1984 with a B.S. degree in Accounting.

Ira M. Goldberg was appointed to the Board in November 2001. Mr. Goldberg has been involved in the financial services and mortgage lending business since 1984. He is the owner of AM Mortgage LLC, a Florida licensed correspondent lender. He previously served as Regional Vice President for Countrywide Homes Loans, a Fortune 500 company, which he joined in February

2000. During 1999, Mr. Goldberg was the Managing Director of Oceanmark/PrimeSource. From 1996 to 1998, Mr. Goldberg was the Senior Vice President of Wholesale Lending for East Coast Operations for Southern Pacific Funding. Prior to 1996, Mr. Goldberg held executive management positions in the mortgage banking industry in New York and Florida. Mr. Goldberg is an active member in the National, Florida and New York Associations of Mortgage Brokers, where he is frequently called upon as a guest speaker and educator. Mr. Goldberg received his B.A. degree in Economics and Business from the State University of New York in New Paltz in 1978.

Michael D. Karsch was appointed to the Board in November 2001. Mr. Karsch has been a partner in the Boca Raton, Florida law firm of Sachs Klein, P.A. since November 2001, where he specializes in the practice of corporate and securities laws. Mr. Karsch has been practicing law since 1985, including with Skadden, Arps, Slate, Meagher & Flom in New York, Bachner Tally Polevoy & Misher in New York, and Broad and Cassel in Florida. He also served as general counsel of MerchantOnline.com, Inc., a provider of e-payment solutions, from May 2000 to April 2001. MerchantOnline.com filed for bankruptcy in October 2001. Mr. Karsch is also a director of Quick-Med Technologies, Inc,. a publicly-traded biotech company. Mr. Karsch received his B.S. degree in Economics from the Wharton School of Business, and his law degree from the University of Pennsylvania Law School.

Richard J. Katz was appointed to the Board in November 2001. Mr. Katz has over 45 years of experience in marketing, advertising, public relations and sales. Upon discharge from the United States Air Force in 1965, he went to work for the Lawrence Fertig Advertising Agency. Three years later, he opened up his own marketing and advertising agency, the Katz, Jacobs and Douglas Advertising Agency in New York, where he served as its president/creative director. In 1980, Mr. Katz co-founded RAMS (real estate advertising, marketing and sales), a provider of multi-services to developers and builders, including research, market studies, architectural collaboration, marketing plan financial presentations, advertising, public relations, sales office design, sales

30

training and on-site sales staffing. During the 1980's, RAMS grew to 200 employees and was involved in more than two billion dollars of properties. Mr. Katz has received more than 100 awards for his creative and marketing accomplishments, including two CLIOS. He also is a past member of the American Management Association, the Presidents Club and the American Academy of Consultants. Mr. Katz was also an instructor/lecturer of marketing/advertising for real estate at the New School for Social Research, an active participant in public service causes such as the New York Library of Presidential Papers, and the author of many innovative recommendations designed to benefit first time home buyers. Mr. Katz is a graduate of Brooklyn College, where he majored in advertising and marketing. Mr. Katz is the father-in-law of David Davidson, who controls, as part of a group, 621,729 shares of the Company's Common Stock, or 15.3% of the Company. See "Voting Security Ownership of Certain Beneficial Owners and Management."

Alan P. Sklar was appointed a Director for the Company in August 2000. Mr. Sklar has been a CPA for 41 years. Mr. Sklar founded the Chicago CPA and management consulting firm, Gleeson, Sklar, Sawyers & Cumpata LLP in 1967, and is presently a senior partner in the firm, where he primarily consults with middle market manufacturers and distributors. Mr. Sklar serves as an advisor to the board for many of his firm's clients. Mr. Sklar also serves on the board of directors of several non-profit business related organizations, and is former president of the International Group of Accounting Firms. Mr. Sklar is a graduate of Northwestern University.

SIGNIFICANT EMPLOYEES

Ellen M. Chambers joined the Company in March 1999 as Controller and became the Director of Information Technologies in March 2000. Ms. Chambers previously acted as Information Systems Coordinator for AIDS Community Services, Inc. She also served as Operations Manager at Advanced Logic Technologies, Inc., a company specializing in custom CAD/CAM design. Ms. Chambers has extensive experience in both accounting and systems development, design and implementation, and has worked in the accounting and information technology fields for over 13 years. Ms. Chambers graduated from the University of Buffalo with a B.S. in Accounting, Finance and Management Information Systems, as well as an MBA in Management Information Systems and Management Science/Statistics.

COMPLIANCE WITH SECTION 16(A) OF THE SECURITIES EXCHANGE ACT OF 1934

To the Company's knowledge, based solely on a review of the copies of such reports furnished to the Company and on representations that no other reports were required, there were no reports required under Section 16(a) of the Securities Exchange Act of 1934, which were not timely filed during fiscal 2002.

ITEM 11. EXECUTIVE COMPENSATION

The following table summarizes all compensation paid by the Company in each of the last three fiscal years to the Company's executive officers currently serving as such whose annual compensation exceeded $100,000.

		Annual Compensation		
Name and Principal Position	Year	Salary($)(1)	Bonus($)	Other($)(
Robert L. Steiler,	2002	0	0	57,924(3)
Acting President	2001	0	0	175,983(4)
	2000	0	0	50,890(5)
John C. Lucy, III (12)	2002	167,084	0	15,196(6)
Chief Executive Officer	2001	172,262	0	14,348(7)
	2000	161,451	0	16,800(8)
Marc S. Steinberg	2002	113,910	0	0
Chief Financial Officer	2001	88,725	0	0
Zachary M. Richardson,	2002	118,875	0	32,648(9)
President until March 2002.	2001	170,878	0	83,200(10)
	2000	161,114	0	59,900(11)

(1) Includes medical insurance reimbursements.

(2) Includes car allowances and other miscellaneous benefits.

(3) The Company appointed Mr. Robert L. Steiler, a Director of the Company, as acting President beginning in March 2002. The Board of Directors agreed to pay Mr. Steiler a sum in addition to his Board Member compensation equal to $2,000 per week plus expenses for these additional responsibilities. The total amount paid by the Company to Mr. Steiler for his services as acting President, inclusive of expenses, was $44,259 during fiscal year 2002. Mr. Steiler also received compensation for his duties as a board member throughout the year for $13,665.

(4) The Lewis Management Group ("LMG"), a firm that provides manufacturing consulting services to the Company, is partially owned by Robert L. Steiler, a Director of the Company. Under a consulting agreement between LMG and the Company, the Company paid LMG $25,000 per month from July 2000 through November 2000 and the Company paid LMG or Mr. Steiler directly for continued consulting services $5,000 per month from December 2000 through June 2001. The total amount paid by the Company to LMG and Mr. Steiler for consulting services, inclusive of expenses, was $162,483 during fiscal year 2001. Mr. Steiler also received compensation for his duties as a board member throughout the year for $13,500.

(5) The Lewis Management Group ("LMG"), a firm that provides manufacturing consulting services to the Company, is partially owned by Robert L. Steiler, a Director of the Company. The Company paid Lewis Management $47,390 during fiscal year 2000. Mr. Steiler also received compensation for his duties as a board member throughout the year for $3,500.

(6) Includes $12,900 for car allowances and other miscellaneous benefits, and $2,296 for payment of Mr. Lucy's Guardian Life policy.

(7) Includes $13,200 for car allowances and other miscellaneous benefits, and $1,148 for payment of Mr. Lucy's Guardian Life policy.

(8) Includes $13,200 for car allowances and other miscellaneous benefits, and $3,600 for reimbursement of moving costs incurred in connection with the purchase of Mr. Lucy's home.

(9) Includes $9,848 for car allowances. Also, Mr. Richardson sold his home at the request of the Company and incurred expenses in connection with this sale. In fiscal year 2002, the Company reimbursed Mr. Richardson $22,800 for his out of pocket costs.

(10) Includes $13,200 for car allowances. Also, Mr. Richardson sold his home at the request of the Company and incurred expenses in connection with this sale. In fiscal year 2001, the Company reimbursed Mr. Richardson $70,000 for his out of pocket costs.

(11) Includes $13,200 for car allowances and $16,800 for reimbursement of income taxes paid. Also, as noted in footnote 3 above, Mr. Richardson sold his home at the request of the Company and incurred expenses in connection with this sale. In fiscal year 2000, the Company reimbursed Mr. Richardson for closing costs in connection with this sale, which totaled $29,900.

(12) Per Mr. Lucy's employment agreement, Mr. Lucy is to receive a stock option grant equal to 1% of the total outstanding at the time of the grant. The Board has not yet approved the grant for fiscal year 2002. The Board is currently in discussions with Mr. Lucy regarding changes to his employment agreement prior to making that grant.

The following table sets forth information concerning individual grants of stock options made during the fiscal year ended June 29, 2002 to each of the Named Executive Officers:

OPTION GRANTS IN LAST FISCAL YEAR

NAME	NUMBER OF SHARES UNDERLYING OPTIONS GRANTED(#)	% OF TOTAL OPTIONS GRANTED TO EMPLOYEES IN FISCAL YEAR	EXERCISE OR BAS PRICE ($/SHARE)
Robert L. Steiler	60,000	9%	.55
John C. Lucy, III	0	0	0
Marc S. Steinberg	30,000	4.56%	.55
Zachary M. Richardson, President until March 2002.	280,000	42%	.55

AGGREGATED OPTION EXERCISES IN LAST FISCAL YEAR AND FY-END OPTION VALUES

Name	Shares Acquired On Exercise (#)	Value Realized ($)	Number Of Securities Underlying Unexercised Options at FY-End (#) Exercisable/ Unexercisable
Robert L. Steiler	0	0	110,000/0
John C. Lucy, III	0	0	558,562/50,583
Marc S. Steinberg	0	0	9,000/28,500
Zachary M. Richardson	0	0	448,075/0

33

COMPENSATION OF DIRECTORS

Starting in fiscal year 2001, the Chairman of the Board is paid a monthly retainer of $1,000 and all other directors are paid a monthly retainer of $500. The directors are paid $1,000 per board meeting day and $500 per teleconference meeting plus all related business expenses. All audit committee members are paid $250 per quarter. All directors are granted 30,000 ten-year options when they are appointed or elected to the board and may be granted additional options for each additional year they are on the board at the then market value. These options may vest over two years at fifty percent per year or upon issuance and when services are terminated, all unexercised options are forfeited. See also "Stock Option Plans."

EMPLOYMENT AGREEMENTS

In November 1998, the Company entered into a five-year employment agreement (the "Employment Agreement") with John C. Lucy, III. Pursuant to the terms of the Employment Agreement, Mr. Lucy is entitled to receive (i) annual base compensation of $156,000, with increases in future years by the percentage increase of the Consumer Price Index and (ii) a bonus up to 100% of base salary based on the increase in pretax earnings per share over the prior year. For the year ending June 29, 2002, Mr. Lucy was not entitled to a bonus. The Employment Agreement also provides for annual grants of common stock options commencing in fiscal 2000 equal to 1% of the then outstanding number of common shares at an exercise price of fair market value at date of grant, and the granting of 150,000 stock appreciation rights that vest only upon a "Change of Control" as defined in the Employment Agreements.

During the term of the Employment Agreement, should there be a Change of Control of the Company as that term is defined therein, the Company, at its sole option, may terminate the Employment Agreement upon 30 days prior written notice and thereafter will be obligated to pay the executive the balance of the compensation payable under the Employment Agreement, had it not been terminated prior to its expiration, together with an additional sum equal to 299% of Executives' annual base compensation. The Employment Agreement also contain non-competition and confidentiality provisions.

STOCK OPTION PLANS

Pallet Management has adopted two combined stock option and appreciation rights plans (the "Plans") to attract and to induce officers, directors and key employees of the Company to remain with the Company. The Plans provide for options which qualify as incentive stock options under Section 422(a) of the Internal Revenue Code of 1986, as amended (the "Code"), as well as nonstatutory options. No more than fifteen percent (15%) of the Common Stock outstanding will be reserved for issuance upon exercise of options to be granted from time-to-time. The 1997 Omnibus Stock Option Plan (the "1997 Plan") was approved in August, 1997. Pallet Management's 1998 Omnibus Stock Option Plan (the "1998 Plan") became effective on September 1, 1998. An aggregate of 250,000 shares are reserved for issuance under the 1997 Plan and 1,000,000 shares are reserved for issuance under the 1998 Plan.

34

As of September 27, 2002, an aggregate of 6,377 options were outstanding under the 1997 Plan with an exercise price of $2.00, and an aggregate of 510,472 options were outstanding under the 1998 Plan with exercise prices ranging from $.54 to $5.25. These options generally vest over a five-year period and expire ten years from date of grant. From 1997 through 2002, the Company granted Messrs. Lucy, III and Steinberg options to acquire an aggregate of 161,072 and 37,500 shares, respectively. See Item 12, "Security Ownership of Certain Beneficial Owners and Management."

The Plans provide for a combined stock option and appreciation rights plan. The Plans provide for options which will qualify as incentive stock options under Section 422(a) of the Internal Revenue Code of 1986, as amended, as well as for options which do not so qualify. Incentive Awards may be granted under the Plans in the form of options, stock appreciation rights, restricted stock, and performance awards.

No more than 50,000 common shares may be allocated to Incentive Awards and no more than 300,000 common shares may be allocated to Non-Incentive Awards granted to any one employee during a single calendar year.

All present and future employees of the Company or of any parent or subsidiary of the Company ("Employee") and any person retained to provide services to the Company (other than as an Employee, a member of the Board of Directors or a member of the board of directors of any subsidiary or parent of the Company), and who is selected by the committee, is eligible to receive Incentive Awards under the Plan.

All present and future Non-Employee Directors are eligible to receive Non-Statutory Options under the Plan. Non-Employee Directors shall not be entitled to receive any other form of Incentive Award under the Plan.

The exercise price of shares of Company Stock covered by an Incentive Stock Option cannot be less than 100% of the fair market value of such shares on the date of grant; provided that if an Incentive Stock Option is granted to an Employee who, at the time of the grant, is a 10% Shareholder, then the exercise price of the shares covered by the Incentive Stock Option will not less than 110% of the fair market value of such shares on the date of grant. The exercise price of Nonstatutory Stock Options will not be less than 85% of fair market value of such shares on the date of grant.

Whenever the Board of Directors of the Company (the "Board") deems it appropriate, stock appreciation rights may be granted in connection with all or any part of an option, either concurrently with the grant of the option or, if the option is a Nonstatutory Stock Option, by an amendment to the option at any time thereafter during the term of the option. Stock appreciation rights may be exercised in whole or in part at such times and under such conditions as may be specified by the Committee in the participant's stock option agreement.

The Board may terminate or amend the Plans in such respects as it shall deem advisable. The Board may unilaterally amend the Plans and Incentive Awards as it deems appropriate to ensure compliance with Rule 16b-3 and to cause Incentive Awards to meet the requirements of the Code, including Code section 422, and regulations thereunder.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION IN COMPENSATION DECISIONS

The Company created its Compensation Committee during fiscal 2001. Mr. Philip D. Feltman (not re-elected to the Board on May 13, 2002) and Mr. Steiler (resigned from the compensation committee upon becoming acting President of the Company) comprised the committee during fiscal year 2002. Michael D. Karsch became Chairman and has served on this Committee since early fiscal 2003 and Ira M. Goldberg began serving on the committee during fiscal 2003. They currently comprise the Board's Compensation Committee.

BOARD COMPENSATION COMMITTEE REPORT ON EXECUTIVE COMPENSATION

General Compensation Policy. The three principal components of the Compensation Committee's executive compensation are salary, bonus and stock options. The components are designed to facilitate fulfillment of the compensation objectives of the Compensation Committee, which objectives include (i) attracting and retaining competent management, (ii) recognizing individual initiative and achievement, (iii) rewarding management for short and long term accomplishments and (iv) aligning management compensation with the achievement of the Company's goals and performance.

The Compensation Committee endorses the position that equity ownership by management is beneficial in aligning management's and shareholders' interest in the enhancement of shareholder value. Base salaries for new management employees are determined initially by evaluating the responsibilities of the position held and the experience of the individual, and by reference to the competitive marketplace for managerial talent, including a comparison of base salaries for comparable position at similar companies of comparable sales and capitalization. Annual salary adjustments are determined by evaluating (i) the performance of and responsibilities assumed by the executive, (ii) the competitive marketplace and (iii) the performance of the Company. The Compensation Committee does not utilize any specific formula to determine compensation based on Company performance.

The Compensation Committee periodically reviews the Company's existing management compensation programs on an ongoing basis, including (i) meetings with the acting President to consider and set mutually agreeable performance standards and goals for members of senior management and/or the Company, as appropriate or as otherwise required pursuant to any such officer's employment agreement and (ii) modifications to such compensation programs as appropriate, to ensure alignment with the philosophy and established standards and goals of the Compensation Committee.

Compensation of President and Chief Executive Officer. The Company has an employment agreement with Mr. John C. Lucy, III, its Chief Executive Officer effective November 1st, 1998. The employment agreement provide for bonuses of up to 100% of base salary based on the increase in pretax earnings per share over the prior year. See "Employment Agreements." Aside from Company performance, other factors that influence the compensation paid to Mr. Lucy includes executive responsibilities and performance, and compensation levels at comparable companies. During fiscal year 2002, Mr. Lucy was not paid a bonus due to company performance.

36

Michael D. Karsch, Chairman
Ira M. Goldberg

COMPARE CUMULATIVE TOTAL RETURN
AMONG PALLET MANAGEMENT SYSTEMS, INC.,
NASDAQ MARKET INDEX AND SIC CODE INDEX

[GRAPHIC OMMITTED]

PERFORMANCE GRAPH

	1997	1998	1999	2000
Pallet Management Systems, Inc.	100.00	614.29	300.00	178.57
SIC Code Index	100.00	105.09	79.17	59.16
NASDAQ Market Index	100.00	132.56	185.76	279.51

Assumes $100 invested on July 1, 1997
Assumes Dividend Reinvested
Fiscal Year Ending June 29, 2002

37

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth, as of the close of business on September 27, 2002 (a) the name, and number of shares of each person known by the Company to be the beneficial owner of more than 5% of the Company's Common Stock and (b) the number of shares of Common Stock owned by each director and all officers and directors as a group, together with their respective percentage holdings of such shares:

NAME AND ADDRESS OF BENEFICIAL OWNER (1)	AMOUNT OF BENEFICIAL OWNERSHIP OF STOCK	PERCENT OF CLASS OUTSTANDING
Robert L. Steiler	111,000 (2)	2.7%
John C. Lucy, III	292,584 (3)	7.1%
Marc S. Steinberg	9,000 (4)	*
Ira M. Goldberg	30,000 (5)	*
Michael D. Karsch	30,000 (5)	*
Richard J. Katz	59,300 (6)	1.5%
Alan P. Sklar	65,000 (7)	1.6%
All Officers and Directors as a Group (seven persons)	596,884 (8)	13.0%
Cromwell Group (9)	931,225 (10)	23.3%
John C. Lucy Jr. (11)	675,696 (12)	16.9%

* Less than 1%

(1) The address of the directors and officers listed above, except for Mr. John C. Lucy, III, is 2855 N. University Drive - Suite 510, Coral Springs, Florida 33065. The address for Mr. John C. Lucy, III is 2900 Highwoods Boulevard, Suite 200, Raleigh, North Carolina 27604.

(2) This figure includes 1,000 shares owned of record by Mr. Steiler and options to acquire 110,000 shares, which options are exercisable within 60 days from the record date

(3) This figure includes 182,097 shares owned of record by Mr. Lucy and his children and options to acquire 110,487 shares, which options are exercisable within 60 days from the record date. This figure excludes options to acquire 50,583 shares, which options are not exercisable within 60 days from the record date. This figure also excludes beneficial ownership of Mr. Lucy Jr., the father of Mr. Lucy III. Together, Mr. Lucy III and Mr. Lucy Jr. (including Clary, see footnote 12 below) beneficially own 682,793 shares of record and options and warrants to acquire 285,487 shares, which options and warrants are exercisable within 60 days from the record date, representing beneficial ownership of a 22.6% equity interest in the Company.

(4) This figure represents options to acquire 9,000 shares, which options are exercisable within 60 days from the record date. It excludes options to acquire 28,500 shares, which options are not exercisable within 60 days from the record date.

(5) This figure represents options to acquire 30,000 shares, which options are exercisable within 60 days from the record date.

(6) This figure includes 29,300 shares owned of record by Mr. Katz and options to acquire 30,000 shares, which options are exercisable within 60 days from the record date.

(7) This figure includes 5,000 shares owned of record by Mr. Sklar and options to acquire 60,000 shares, which options are exercisable within 60 days from the record date

(8) This figure includes 217,397 shares owned of record by the Company's directors and executive officers as a group, and options to acquire 379,487 shares as a group, which options are exercisable within 60 days from the record date. This figure excludes options to acquire 79,083 shares as a group, which options are not exercisable within 60 days from the record date.

(9) The "Cromwell Group" consists of D.L. Cromwell LLC, a Florida limited liability company ("Cromwell-Parent"), David Davidson ("Davidson"), Lloyd Beirne ("Beirne"), and Lawrence and Connie Loscalzo (the "Loscalzos"). Cromwell-Parent is a holding company for D.L. Cromwell Investments, Inc. ("Cromwell Investments"), a registered broker-dealer engaged in the securities business. Davidson and Beirne might be deemed to control Cromwell-Parent and thus Cromwell Investments also. The Loscalzos are individuals and clients of Cromwell Investments. Although Cromwell-Parent, Cromwell Investments and the Loscalzos do not jointly own any securities of the Company, they would likely act as a group in voting their shares of the Company's common stock. The address of Cromwell-Parent, Cromwell Investments and Messrs. Davidson and Beirne is 1200 North Federal Highway, Boca Raton, Florida 33432. The address of the Loscalzos is 1 Bouton Point, Lloyd Harbor, New York 11743. The information disclosed by the Company about Cromwell-Parent, Cromwell Investments and the Loscalzos is based upon a Schedule 13D jointly filed by Cromwell and the Loscalzos with the United States Securities and Exchange Commission on October 3, 2003, and updated information supplied by Mr. Davidson.

(10) Cromwell-Parent and Cromwell Investments own 332,050 shares and 124,675 shares, respectively, for an aggregate of 456,725 shares or 11.4% of the Company's Common Stock; the Loscalzos own 300,500 shares, or 7.5%, of the Company's Common Stock; and Messrs. Davidson and Beirne directly or indirectly beneficially own an additional 131,500 shares or 3.3%, and 42,500 shares or 1.1%, respectively of the Company's Common Stock besides the shares beneficially owned by Cromwell-Parent and Cromwell Investments. Although Cromwell-Parent, Cromwell Investments, Messrs. Davidson and Beirne, and the Loscalzos do not jointly own any securities of the Company, they would likely act as a group in voting their shares of the Company's Common Stock.

This 131,500 shares directly or indirectly owned by Mr. Davidson consist of 35,400 shares owned of record by Mr. Davidson, 19,600 shares held in individual retirement accounts for his benefit, and 50,000 shares held by MidSouth Ltd., 1,000 shares held by MidSouth LLC and 25,500 shares held by Rothchild Capital Holdings, in each of which Mr. Davidson's wife has an ownership interest. The 42,500 shares directly or indirectly owned by Mr. Beirne consist of 12,500 shares held by Mr. Beirne as custodian for his minor children and 30,000 shares held by MidAtlantic Partnership, LLC, in which Mr. Beirne's wife has an ownership interest.

(11) The address of Mr. John C. Lucy, Jr. is 4755 Liberty Road, Dolphin, Virginia 23843.

(12) This figure includes 450,696 shares owned of record by Mr. Lucy Jr., the father of Mr. Lucy III, and options to acquire 125,000 shares, which options are exercisable within 60 days from the record date. This figure also includes 50,000 shares owned of record by Clary Lumber Company, Inc., a North Carolina corporation ("Clary"), and warrants to acquire 50,000 shares, which warrants are exercisable within 60 days from the record date. Mr. Lucy Jr. owns two-thirds of Clary, with the other one-third ownership shared between Mr. Lucy III and his sister. This figure does not include beneficial ownership of Mr. Lucy III. Together, Mr. Lucy Jr. (including Clary) and Mr. Lucy III own 682,793 shares of record and options and warrants to acquire 285,487 shares, which options and warrants are exercisable within 60 days from the record date, representing beneficial ownership of a 22.6% equity interest in the Company

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The Company's Board of Directors appointed Robert L. Steiler, a Director of the Company, as acting President beginning in March 2002. The Board of Directors agreed to pay Mr. Steiler a sum in addition to his Board Member compensation equal to $2,000 per week plus expenses for these additional responsibilities. The total amount paid by the Company to Mr. Steiler for his services as acting President, inclusive of expenses, was $44,259 during fiscal year 2002.

Mr. Steiler is also one of the owners of Lewis Management Group ("LMG"), a firm that provides manufacturing consulting services to the Company. The Lewis Management Group ("LMG") employed Ed Carr, who acted in the capacity for the Company as the Director of Manufacturing Operations from July 2000 until June 2001. The Company began paying Integrated Consulting Associates, Inc., Mr. Carr's consulting company, for his consulting services directly beginning in December 2000 at the rate of $20,000 per month. The total amount paid by the Company to Integrated Consulting Associates, Inc., inclusive of expenses, for fiscal year 2002 was $19,889. Mr. Carr also received warrants for 10,000 shares on May 17, 2001 with a $3.09 exercise price. The company discontinued Mr. Carr's consulting services in August 2001 and re-established those services in June 2002.

Clary Lumber Company, Inc., a North Carolina corporation ("Clary"), which is owned by the family of John C. Lucy, Jr., a principal shareholder and former Director of Pallet Management, and his son, John C. Lucy III, who is Pallet

40

Management's CEO, sold $1,539,000, $2,455,000 and $2,633,000 of pallets and lumber to the Company during the fiscal years 2002, 2001 and 2000, respectively. Lumber purchases from Clary amounted to 4%, 4% and 6% of the Company's lumber purchases for fiscal years 2002, 2001 and 2000, respectively. The Company closely monitors these transactions and believes that these transactions were, and are, made at prices comparable to vendors other than Clary in the ordinary course of business.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a) Exhibits and Financial Statements and Schedules

(1) Financial Statements:

See Attached.

(2) Financial Statement Schedules:

See Attached.

(3) Exhibits:

See Exhibit Index.

(b) Reports on Form 8-K

None.

41

EXHIBIT INDEX

Exhibit No.	Description
3.1	Articles of Incorporation. (1)
3.2	Amendment to Articles of Incorporation filed June 7, 1985. (1)
3.3	Amendment to Articles of Incorporation filed July 10,1985. (1)
3.4	Amendment to Articles of Incorporation filed October 12, 1994. (1)
3.5	Amendment to Articles of Incorporation filed November 21, 1994. (1)
3.6	Amendment to Articles of Incorporation filed February 3, 1998. (2)
3.7	Amended and Restated By-Laws. (1)
4.1	Specimen Certificate of Common Stock. (1)
10.1	1997 Omnibus Stock Plan. (3)

10.2	1998 Omnibus Stock Plan. (4)
10.3	Employment Agreement between the Company and John C. Lucy, III. (5)
21	Subsidiaries *

(1) Incorporated by reference to the Registrant's Annual Report on Form 10-KSB for the fiscal year ended June 30, 1996.

(2) Incorporated by reference to the Registrant's Registration Statement on Form SB-2 (SEC File Number 333-46245).

(4) Incorporated by referenced to the Annual Report on Form 10-K for the fiscal year ended June 30, 1998.

(5) Incorporated by reference to the Registrant's Proxy Statement filed November 30, 1998.

(6) Incorporated by reference to the Registrant's Quarterly Report on Form 10-QSB for the period ended December 26, 1998.

* Filed herewith.

42

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Date: October 11, 2002

By: /s/ John C. Lucy III
John C. Lucy III, CEO

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

SIGNATURE	TITLE
/s/ John C. Lucy, III John C. Lucy, III	Chief Executive Officer
/s/ Marc S. Steinberg Marc S. Steinberg	Vice President, Chief Financial Officer, Secretary and Treasurer

/s/ Alan P. Sklar Alan P. Sklar	Director
/s/ Robert L. Steiler Robert L. Steiler	Director and Interim President
/s/ Michael D. Karsch Michael D. Karsch	Director
/s/ Ira M. Goldberg Ira M. Goldberg	Director
/s/ Richard J. Katz Richard J. Katz	Director

43

CERTIFICATIONS

I, John C. Lucy, III, certify that:

1. I have reviewed the Registrant's Form 10-K annual report for the year ended June 29, 2002 (the "Report").

2. Based on my knowledge, the Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the Report.

3. Based on my knowledge, the financial statements, and other financial information included in the Report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in the Report.

/s/ John C. Lucy, III

Name: John C. Lucy, III
Title: Chief Executive Officer
(Chief Executive Officer)

I, Marc S. Steinberg, certify that:

1. I have reviewed the Report.

2. Based on my knowledge, the Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements

were made, not misleading with respect to the period covered by the Report.

3. Based on my knowledge, the financial statements, and other financial information included in the Report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in the Report.

/s/ Marc S. Steinberg

Name: Marc S. Steinberg
Title: Vice President and Chief Financial Officer
(Chief Financial Officer)

EXPLANATORY NOTE REGARDING CERTIFICATIONS: Representations 4, 5 and 6 of the Certification as set forth in this Form 10-K have been omitted, consistent with the Transition Provisions of SEC Exchange Act Release No. 34-46427, because this Annual Report on Form 10-K covers a period ending before the Effective Date of Rules 13a-14 and 15d-14.

PALLET MANAGEMENT SYSTEMS, INC.

AND SUBSIDIARIES

FINANCIAL STATEMENTS

JUNE 29, 2002

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors and Stockholders
Pallet Management Systems, Inc.

We have audited the accompanying consolidated balance sheet of Pallet Management Systems, Inc. and Subsidiaries as of June 29, 2002 and June 30, 2001, and the related consolidated statements of operations, stockholders' equity and cash flows for the years ended June 29, 2002 (52 weeks), June 30, 2001 (53 weeks) and June 24, 2000 (52 weeks). These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Pallet Management Systems, Inc. and Subsidiaries as of June 29, 2002 and June 30, 2001, and the results of their operations and their cash flows for the years ended June 29, 2002 (52 weeks), June 30, 2001 (53 weeks) and June 24, 2000 (52 weeks), in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note B, the Company may have difficulty meeting current and long-term obligations. This factor raises substantial doubt about the Company's ability to continue as a going concern. Management's plans are also discussed in Note B. The financial statements do not include any adjustments relating to the recoverability and classification of recorded assets, or the amounts and classification of liabilities that might be necessary in the event the Company cannot continue in existence.

KAUFMAN, ROSSIN & CO.

Miami, Florida
August 22, 2002

PALLET MANAGEMENT SYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

JUNE 29, 2002 AND JUNE 30, 2001

	2002	
ASSETS		
CURRENT ASSETS		
Cash	$ 72,561	$
Accounts receivable, net of allowance for doubtful accounts of $106,749 and $156,655	3,503,750	
Inventories	1,098,946	
Prepaid expenses	203,091	
Total current assets	4,878,348	
Property, plant and equipment - net	4,925,451	
Other assets	91,447	
Total assets	$ 9,895,246	$ 1

LIABILITIES AND STOCKHOLDERS' EQUITY

CURRENT LIABILITIES		
Current maturities of long-term debt	$ 947,060	$
Current portion of capital lease obligations	139,740	
Accounts payable, including $115,081 and $17,392 to a related party	2,062,277	
Accrued liabilities	426,503	
Total current liabilities	3,575,580	
LONG-TERM LIABILITIES		
Long-term debt	4,072,936	
Capital lease obligations	152,546	
Total long-term liabilities	4,225,482	
Total liabilities	7,801,062	
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY		
Preferred stock, authorized 7,500,000 shares at $.001 par value; no shares issued and outstanding	--	
Common stock, authorized 100,000,000 shares at $.001 par value; issued and outstanding 3,995,612 and 4,065,612 shares, respectively	3,996	
Additional paid-in capital	7,148,784	
Accumulated deficit	(4,920,596)	(
Notes receivable from stockholders	(138,000)	
Total stockholders' equity	2,094,184	
Total liabilities and stockholders' equity	$ 9,895,246	$ 1

The accompanying notes are an integral part of these statements.

PALLET MANAGEMENT SYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

YEARS ENDED JUNE 29, 2002 (52 WEEKS) JUNE 30, 2001 (53 WEEKS),
AND JUNE 24, 2000 (52 WEEKS)

	2002	2001	2000
Net sales	$ 47,799,439	$ 72,167,233	$ 62,445,175
Cost of goods sold, including approximately $1,539,000, $2,455,000 and $2,633,000 from a related party	44,810,597	67,035,408	59,097,842
Gross profit	2,988,842	5,131,825	3,347,333

OPERATING EXPENSES			
Provision for bad debts	25,000	142,134	95,436
Selling, general and administrative	3,656,120	4,178,585	4,803,655
Total operating expenses	3,681,120	4,320,719	4,899,091
Operating income (loss)	(692,278)	811,106	(1,551,758)
Other income (expense)			
Other income	16,513	41,655	84,629
Interest expense	(379,864)	(528,078)	(551,444)
Other expense	(88,795)	(21,699)	(231,394)
Other income (expense)	(452,146)	(508,122)	(698,209)
Income (loss) before income taxes	(1,144,424)	302,984	(2,249,967)
Income taxes	--	--	--
Net income (loss)	$ (1,144,424)	$ 302,984	$ (2,249,967)
Earnings (loss) per common share:			
Basic	$ (0.28)	$ 0.07	$ (0.57)
Diluted	$ (0.28)	$ 0.07	$ (0.57)
Shares used in computing earnings (loss) per common share:			
Basic	4,028,973	4,065,612	3,981,199
Diluted	4,028,973	4,258,484	3,981,199

The accompanying notes are an integral part of these statements.

PALLET MANAGEMENT SYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

YEARS ENDED JUNE 29, 2002 (52 WEEKS), JUNE 30, 2001 (53 WEEKS) AND JUNE 24, 2000 (52 WEEKS)

	Common Stock	Additional	Notes Receivable

	------------ Shares	Amount	Paid-in Capital	From Stockholders	Accum Def
Balance at June 26, 1999	3,917,612	$ 3,918	$ 6,958,704	$ --	$(1,8
Exercise of options	138,000	138	275,862	(276,000)	
Common stock issued for services	10,000	10	34,990	--	
Sale of investments	--	--	--	--	
Net loss	--	--	--	--	(2,2
Balance at June 24, 2000	4,065,612	4,066	7,269,556	(276,000)	(4,0
Net income	--	--	--	--	3
Balance at June 30, 2001	4,065,612	4,066	7,269,556	(276,000)	(3,7
Repayment of shareholder note with stock	(70,000)	(70)	(137,930)	138,000	
Common stock options issued for services	--	--	17,158	--	
Net loss	--	--	--	--	(1,1
Balance at June 29, 2002	3,995,612	$ 3,996	$ 7,148,784	$ (138,000)	$(4,9

(1) Consisting of unrealized gains on available-for-sale securities.

The accompanying notes are an integral part of these statements.

F-4

PALLET MANAGEMENT SYSTEMS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

YEARS ENDED JUNE 29, 2002 (52 WEEKS), JUNE 30, 2001 (53 WEEKS) AND JUNE 24, 2000 (52 WEEKS)

	2002	2001	2000
Cash flows from operating activities:			
Net income (loss)	$(1,144,424)	$ 302,984	$(2,249,
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Bad debt expense	25,000	142,134	95,
Depreciation and amortization	765,409	654,133	602,

Impairment loss	154,750	--	
Issuance of common stock and options for services	17,158	--	35,
Loss on disposal of property, plant and equipment	3,347	2,876	226,
(Increase) decrease in operating assets:			
Accounts receivable	1,085,861	128,556	(2,328,
Inventories	942,543	217,621	(392,
Prepaid expenses	55,767	(21,281)	(81,
Other assets	341	12,596	12,
Increase (decrease) in operating liabilities:			
Accounts payable	(977,289)	279,349	1,636,
Accrued liabilities	(83,449)	(304,125)	300,
Net cash provided by (used in) operating activities	845,014	1,414,843	(2,142,
Cash flows from investing activities:			
Purchase of fixed assets	(66,587)	(905,805)	(1,119,
Proceeds from sale of property, plant and equipment	8,000	--	221,
Net cash used in investing activities	(58,587)	(905,805)	(897,
Cash flows from financing activities:			
Proceeds (repayments) under line of credit, net	(211,195)	(1,342,305)	1,837,
Proceeds from lenders	230,657	1,170,264	3,631,
Repayments to lenders	(965,963)	(681,414)	(2,113,
Net cash provided by (used in) financing activities	(946,501)	(853,455)	3,355,
Increase (decrease) in cash	(160,074)	(344,417)	314,
Cash at beginning of period	232,635	577,052	262,
Cash at end of period	$ 72,561	$ 232,635	$ 577,
Supplemental disclosure of cash flow information:			
Cash paid during the period for:			
Interest	$ 387,893	$ 498,344	$ 512,
Income taxes	$ --	$ --	$

Schedule of non-cash investing and financing activities:

Capital lease obligations of $150,015, $103,988 and $78,896 were incurred during the years ended June 29, 2002, June 30, 2001, and June 24, 2000, respectively.

During the year ended June 30, 2001, $880,479 of deposits on machinery and software costs were transferred to property and equipment.

In January 2000, stockholders of the Company issued notes receivable to the

Company in the aggregate amount of $276,000 for the exercise of stock options.

In December 2001, 70,000 shares of common stock were submitted to the Company to pay the principal balance of a $138,000 note receivable from a stockholder.

The accompanying notes are an integral part of these statements.

F-5

PALLET MANAGEMENT SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 29, 2002 (52 WEEKS), JUNE 30, 2001 (53 WEEKS) AND JUNE 24, 2000 (52 WEEKS)

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A summary of the Company's significant accounting policies consistently applied in the preparation of the accompanying consolidated financial statements is as follows:

1. Nature of Operations

Pallet Management Systems, Inc. and Subsidiaries (the "Company"/"Pallet") is principally engaged in the manufacture and repair of wooden pallets in Virginia, Alabama, Illinois and Indiana. The Company's revenues are derived primarily from the sale of new and used pallets. The Company's fiscal year ends on the Saturday closest to June 30. Fiscal years 2002 and 2000 included 52 weeks and fiscal year 2001 included 53 weeks.

2. Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries Pallet Recycling Technology, Inc. ("PRTI"), Abell Lumber, Inc. ("Abell"), Pallet Management Systems of Alabama, Inc., Pallet Management Systems of Illinois, Inc. and Pallet Management Systems of Indiana, Inc. Intercompany balances and transactions are eliminated in consolidation.

3. Accounts Receivable

Trade receivable accounts are principally comprised of uncollateralized customer obligations due from large distributors, national retail chains and major manufacturers under normal trade terms. The carrying amount of accounts receivable is reduced by an allowance that reflects management's best estimate of the amounts that will not be collected. Management individually reviews all accounts receivable balances and based on an assessment of current creditworthiness, estimates the portion, if any, of the balance that will not be collected.

4. Inventories

Inventories, consisting of raw materials, work in process, and finished goods, are stated at the lower of cost or market. Cost is determined by the first-in, first-out method and includes costs of materials, direct and indirect labor and overhead attributable to production.

PALLET MANAGEMENT SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

JUNE 29, 2002 (52 WEEKS), JUNE 30, 2001 (53 WEEKS) AND JUNE 24, 2000 (52 WEEKS)

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

5. Property, Plant and Equipment

Property, plant and equipment are stated at cost, net of accumulated depreciation. Major renewals and improvements are capitalized. Repairs and maintenance are expensed as incurred. Depreciation is principally computed by using the straight-line method over the expected useful lives of the related assets which are as follows:

	Years
Furniture and equipment	5 - 10
Vehicles	5 - 10
Machinery and equipment	5 - 15
Buildings and improvements	7 - 40

Depreciation on certain machinery in Indiana is based on the estimated units to be produced by the machinery.

6. Estimates

In preparing financial statements in accordance with accounting principles generally accepted in the United States of America, management makes estimates and assumptions that affect the reported amounts and disclosures of assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

The Company has recorded deferred tax assets of approximately $1,721,000 and $1,298,000 at June 29, 2002 and June 30, 2001, respectively, which are completely offset by valuation allowances. Realization of the deferred tax asset is dependent on generating sufficient taxable income in the future. The amount of the deferred tax asset considered realizable could change in the near term if estimates of future taxable income are modified.

7. Income Taxes

The Company accounts for income taxes under the liability method. Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the consolidated financial statements carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

PALLET MANAGEMENT SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

JUNE 29, 2002 (52 WEEKS), JUNE 30, 2001 (53 WEEKS) AND JUNE 24, 2000 (52 WEEKS)

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

8. Earnings (Loss) Per Share

Basic earnings (loss) per common share is computed using the weighted average number of shares outstanding during the period. Diluted earnings (loss) per common and common equivalent share is computed using the weighted average number of shares outstanding during the period adjusted for incremental shares attributed to outstanding options and warrants to purchase common stock of 192,872 for the year ended June 30, 2001. For the years ended June 29, 2002 and June 24, 2000, outstanding stock options and warrants were not considered in the calculation of diluted earnings (loss) per common and common equivalent share as their effect would have been antidilutive. Securities that could potentially dilute basic earnings per share in the future consist of 1,767,505 options to purchase common stock discussed in Note N.

9. Financial Instruments

Statement of Financial Accounting Standards No. 107 requires disclosure of the estimated fair value of financial instruments. The carrying values of cash, accounts receivable and accounts payable approximate fair value due to the short-term maturities of these instruments. The carrying value of debt approximates fair value due to the length of the maturities, the interest rates being tied to market indices and/or due to the interest rates not being significantly different from the current market rates available or offered to the Company.

10. Stock Options (SFAS 123)s

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 (SFAS 123), 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.

11. Concentration of Credit

The Company, from time to time, maintained deposits at financial institutions in excess of federally insured limits. The Company is currently monitoring amounts on deposit at the financial institutions.

12. Comprehensive Income

Comprehensive income is not reported in the accompanying consolidated financial statements as it is not materially different from net income.

PALLET MANAGEMENT SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

JUNE 29, 2002 (52 WEEKS), JUNE 30, 2001 (53 WEEKS) AND JUNE 24, 2000 (52 WEEKS)

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

13. 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" (SFAS 143), 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.

Management believes adoption of these statements will not have a material effect on the consolidated financial statements of the Company.

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" (SFAS 144), effective for fiscal years beginning after December 15, 2001 with earlier application encouraged. This statement addresses financial accounting and reporting for the impairment or disposal of long-lived assets. The Company adopted SFAS 144 during the current year, which did not have a material impact on the Company's financial statements. However, the Company did recognize an impairment loss on certain long-lived assets as discussed in Note D.

In April 2002, the FASB issued SFAS No. 145, "Rescission of FASB Statement No's. 4, 44, and 64, Amendment of FASB Statement No. 13 and Technical Corrections" (SFAS 145). This statement, among other things, eliminates an inconsistency between required accounting for certain sale-leaseback transactions and provides for other technical corrections. Management believes adoption of this statement will not have a material effect on the consolidated financial statements of the Company.

PALLET MANAGEMENT SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

JUNE 29, 2002 (52 WEEKS), JUNE 30, 2001 (53 WEEKS) AND JUNE 24, 2000 (52 WEEKS)

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - Continued

13. New Accounting Pronouncements (continued)

In June 2002, the FASB issued SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities" (SFAS 146). This statement addresses accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force Issue No. 94-3. The statement is effective for exit or disposal costs initiated after December 31, 2002, with early application encouraged. The Company has not yet adopted this statement, and management has not determined the impact of this statement on the financial statements of the Company.

14. Segment Reporting

The Company applies Financial Accounting Standards Board ("FASB") statement No. 131, "Disclosure about Segments of an Enterprise and Related Information". The Company has considered its operations and has determined that it operates in a single operating segment for purposes of presenting financial information and evaluating performance. As such, the accompanying financial statements present information in a format that is consistent with the financial information used by management for internal use.

NOTE B - GOING CONCERN

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplates continuation of the Company as a going concern. However, as discussed in Note O, the Company's remaining manufacturing agreement with its significant customer expires in March 2003. This factor indicates that the Company may have difficulty meeting current and long-term obligations as they become due.

The Company has had over a ten-year relationship with its significant customer and is currently negotiating a new agreement with this customer. Because of the new pricing arrangement between the significant customer and the Company, the Company believes that, whether there is a new agreement or not, the significant customer will continue to buy pallets from the Company.

However, the new pricing arrangement with the significant customer will put added pressure on the Company's profit margins during the historically slow period during the first calendar quarter of 2003. In order to compensate for that and the loss of revenue and income from the closing of the Alabama and Illinois facilities, the Company is 1) attempting to develop an increase in its order base from its other existing customers and by developing a larger market for the pallet manufacturing facility in Lawrenceville, Virginia and 2) developing and marketing its reverse distribution services.

In view of these matters, realization of a major portion of the assets in the accompanying balance sheet is dependent upon continued operations of the Company, which in turn is dependent upon the Company's ability to meet its financial obligations. Management believes that actions presently being taken, as described in the preceding paragraph, provide the opportunity for the Company to continue as a going concern, however, there is no assurance this will occur.

NOTE C - INVENTORIES

Inventories consisted of the following:

	June 29, 2002	June 30, 2001
Raw materials	$ 851,124	$1,333,846
Work in process	14,245	454,991
Finished goods	233,577	252.652
	$1,098,946	$2,041,489

NOTE D - PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consisted of the following:

	June 29, 2002	June 30, 2001
Machinery and equipment	$6,363,692	$6,654,079
Building and improvements	1,623,000	1,623,000
Vehicles	403,439	541,709
Furniture and equipment	884,055	795,588
Land	136,044	136,044
	9,410,230	9,750,420
Less: accumulated depreciation and amortization	4,484,779	4,110,065
	$4,925,451	$5,640,355

Depreciation and amortization expense was $ 765,409, $654,133, and $602,230 in 2002, 2001 and 2000, respectively, and is included in "cost of goods sold" and "selling, general and administrative" expenses in the accompanying consolidated statements of operations. Property, plant and equipment at June 29, 2002 and June 30, 2001 included assets recorded under capital leases and related accumulated amortization of approximately $681,000 and $198,000, and $467,000 and $104,000, respectively. Amortization expense related to assets under capital leases was approximately $74,000, $43,000 and $38,000 in 2002, 2001 and 2000, respectively.

Due to the closing of the Alabama and Illinois facilities and the notification of non-renewal of the manufacturing agreement in Indiana by the Company's major customer, as discussed in Note O, in accordance with SFAS No. 144, the Company tested certain long-lived assets for recoverability. Based on a future cash flow analysis, management determined that certain equipment was impaired. Management obtained an independent valuation of the equipment to determine its fair value and recorded an impairment loss of approximately $155,000, which is included in selling, general and administrative expenses in the accompanying consolidated statements of operations.

NOTE E - OTHER ASSETS

Other assets consisted of the following:

	June 29, 2002	June 30, 2001
Security deposits	87,572	84,463
Other	3,875	7,325
	$91,447	$91,788

NOTE F - INCOME TAXES

The income tax benefit consisted of the following:

	Years Ended		
	June 29, 2002	June 30, 2001	June 24, 2000
Current:			
Federal	$ --	$ --	$ --
State	--	--	--
	--	--	--
Deferred:			
Federal	(383,211)	123,107	(759,622)
State	(40,480)	11,952	(80,784)
Change in valuation allowance	423,691	(135,059)	840,406
	--	--	--
	$ --	$ --	$ --

Deferred income taxes were recognized in the consolidated balance sheets due to the tax effect of temporary differences and loss carryforwards as follows:

	June 29, 2002	June 30, 2001
Deferred tax assets:		
Net operating loss carryforwards	$2,163,879	$1,678,315
Other	80,285	106,590
	2,244,164	1,784,905
Deferred tax liabilities:		
Depreciation	522,784	487,216
Net deferred tax asset	1,721,380	1,297,689
Less: valuation allowance	1,721,380	1,297,689
	$ --	$ --

PALLET MANAGEMENT SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

JUNE 29, 2002 (52 WEEKS), JUNE 30, 2001 (53 WEEKS) AND JUNE 24, 2000 (52 WEEKS)

NOTE F - INCOME TAXES - Continued

The major elements contributing to the difference between the income tax benefit and the amount computed by applying the federal statutory tax rate to income (loss) before income taxes are as follows:

	Years Ended		
	June 29, 2002	June 30, 2001	June 24, 2000
Statutory rate	$(389,104)	$ 103,015	$(764,989)
State income taxes	(40,480)	11,962	(80,784)
Change in valuation allowance	423,691	(135,059)	840,406
Permanent differences and other	5,893	20,082	5,367
	$ --	$ --	$ --

As of June 29, 2002, the Company had net operating loss carryforwards of approximately $5,750,000 which expire in various years through June 2022. Approximately $976,000 of these net operating losses are subject to substantial restrictions imposed under the change in ownership and separate return limitation year rules.

NOTE G - LONG-TERM DEBT

June 29,

$5,000,000 revolving credit agreement with a bank. Interest is paid monthly at the bank's prime rate plus 1.0% or at the borrower's election LIBOR plus 3.25%. As of June 29, 2002, interest was being charged at 5.75%, the bank's prime rate plus 1.0%. The line is collateralized by substantially all the assets of the Company, and expires on October 15, 2003 at which time all principal and accrued interest is due. Advances are based on 85% of eligible accounts receivable and 55% of eligible inventories, as defined, less certain other outstanding obligations.	$ 1,693
Bank note payable in monthly installments of approximately $21,000 plus interest at the bank's prime rate plus 1.0% or at the borrower's election LIBOR plus 3.25%, through October 15, 2003 at which time all principal and accrued interest is due. As of June 29, 2002, interest was being charged at 5.75%, the bank's prime rate plus 1.0%. The note is collateralized by substantially all the assets of the Company.	1,257
Bank note payable in monthly installments of $11,567 plus interest at the bank's prime rate plus 1.0% or at the borrower's election LIBOR plus 3.25%, through October 15, 2003 at which time all principal and accrued interest is due. As of June 29, 2002, interest was being charged at 5.75%, the bank's prime rate plus 1.0%. The note is collateralized by substantially all the assets of the Company.	1,087

PALLET MANAGEMENT SYSTEMS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - CONTINUED

JUNE 29, 2002 (52 WEEKS), JUNE 30, 2001 (53 WEEKS) AND JUNE 24, 2000 (52 WEEKS)

NOTE G - LONG-TERM DEBT - Continued

Bank note payable in monthly installments of $17,188 plus interest at the bank's prime rate plus 1.0% or at the borrower's election LIBOR plus 3.25%, through October 15, 2003 at which time all principal and accrued interest is due. As of June 29, 2002, interest was being charged at 5.75%, the bank's prime rate plus 1.0%. The note is collateralized by substantially all the assets of the Company.	842,226
Industrialized development notes payable in quarterly installments of $3,381, including interest at 5.25%, maturing October 2017 and uncollateralized.	139,936
Notes payable in monthly installments of $440 to $3,343, including interest ranging from 8% to 16%, collateralized by equipment and vehicles, maturing at various dates through February 2002.	--
Total debt	5,019,996
Less: current maturities of long-term debt	947,060
Long-term debt	$ 4,072,936

The revolving credit agreement and bank notes payable are subject to certain restrictive covenants including, but not limited to, minimum tangible net worth and interest and debt service coverage ratios, as defined. The agreement also provides restrictions as to the payment of dividends. The Company was in violation of certain covenants at June 29, 2002 and received waivers from the lender related to these violations.

Interest expense for the years ended June 29, 2002, June 30, 2001 and June 24, 2000 amounted to $379,864, $528,078 and $551,444, respectively, and is included in other expense in the accompanying consolidated statements of operations.

Scheduled maturities of long-term debt for years subsequent to June 29, 2002 are as follows:

2003	947,060
2004	3,945,516
2005	6,781
2006	7,155
2007	7,549
Thereafter	105,935
	$ 5,019,996

NOTE H - CAPITAL LEASE OBLIGATIONS

Minimum future annual lease payments under capital leases as of June 29, 2002, in the aggregate, including a $100,414 lease entered into in July 2002, are as follows:

2003	183,077
2004	109,995
2005	62,747
2006	49,825
2007	33,567
Total minimum future lease payments	439,211
Less: imputed interest	75,889
Present value of future minimum lease payments	363,322
Less: current portion of capital lease obligations	149,924
Long-term portion of capital lease obligations	$ 213,398

NOTE I - ACCRUED LIABILITIES

Accrued liabilities consisted of the following:

	June 29, 2002	June 30, 2001

Accrued compensation	$ 122,929	$ 154,998
Other accrued liabilities	303,574	354,954
	$ 426,503	$ 509,952

NOTE J - COMMITMENTS

1. Operating Leases

The Company leases manufacturing facilities, office space, equipment and vehicles under non-cancelable operating leases. The following is a schedule, by year, of the minimum rental commitments remaining on leased property and equipment:

2003	$ 592,449
2004	441,913
2005	93,524
2006	23,622
Total	$ 1,151,508

Total rent expense was approximately $1,032,000, $999,000 and $1,030,000 for the years ended June 29, 2002, June 30, 2001 and June 24, 2000, respectively.

NOTE K - RELATED PARTY TRANSACTIONS

The Company purchased approximately $1,539,000, $2,455,000 and $2,633,000 of lumber and pallets from Clary Lumber Company, Inc. ("Clary") a company principally owned by a shareholder of Pallet, during the years ended June 29, 2002, June 30, 2001, June 24, 2000, respectively. Lumber purchases from Clary amounted to approximately 4%, 4% and 6% of the Company's lumber purchases for the years ended June 29, 2002, June 30, 2001 and June 24, 2000, respectively.

NOTE L - EMPLOYMENT AND CONSULTING AGREEMENTS

The Company has an employment agreement with a senior executive that provides for, among other things, annual compensation of $156,000, a bonus based on diluted earnings per share, stock appreciation rights to vest upon a change of control, as defined, and stock options to be granted annually. The agreement is cancellable by the Company upon 30 days written notice to the executive and payment of requisite compensation, and expires on October 31, 2003.

NOTE M - STOCKHOLDERS' EQUITY

In January 2000, the Company loaned two officers an aggregate of $276,000 to exercise options to purchase an aggregate of 138,000 shares of common stock. In December 2001, one shareholder satisfied his note of $138,000 by submitting 70,000 shares of common stock to the Company. The remaining loan bears interest at 5% per annum, with interest payments due annually and principal due the earlier of January 12, 2003 or upon registering the shares. The note is collateralized by mature shares of stock previously owned by the stockholder. The loans receivable are recorded as a separate component of stockholders' equity in the accompanying consolidated balance sheets.

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 former President. 460,000 of these options vested upon grant while the remainder vest through July 1, 2006. All options are exercisable at $.55 per share and expire in October 2011.

In December 2001, the former President exercised options to acquire 280,000 shares of common stock through the transfer of 88,000 mature shares. On July 11, 2002, the former President and the Company entered into a settlement agreement rescinding the exercise of the stock options. The accompanying consolidated financial statements give effect to the rescission.

NOTE N - STOCK BASED COMPENSATION

In April 1997 and September 1998, the Company established Stock Option Plans which authorize the Company to issue options to employees, directors and outside consultants of the Company. The issuance and form of the options shall be at the discretion of the Company's board of directors, except that the exercise price may not be less than 85% of the fair market value at the time of grant. The options vest over a four year period and expire in ten years or three months after separation of service, whichever occurs earlier.

NOTE N - STOCK BASED COMPENSATION (Continued)

The Company has elected to follow Accounting Principles Board Opinion No. 25 "Accounting for Stock Issued to Employees" (APB 25") in accounting for its employees stock options. Under APB 25, because the exercise price of the Company's employee stock options issued was greater than the market price of the underlying stock on the date of grant, no compensation expense was recognized.

Statement of Financial Accounting Standards No. 123 "Accounting for Stock-based Compensation," ("SFAS No. 123") requires the Company to provide proforma information regarding net income (loss) and earnings (loss) per common share as if compensation cost for the Company's Stock Option Plan had been determined in accordance with the fair value based method prescribed in SFAS No. 123. The Company estimated the fair value of each stock option on the date of grant by using the Black-Scholes pricing model with the following assumptions: expected volatility of 75%; expected life of the option of 75% of the stated life for 10 year options and the stated life for all others; no dividends; and a risk free interest rate of approximately 4%.

Under the accounting provisions of SFAS No. 123, the Company's net income (loss) and basic and diluted earnings (loss) per common share for the years ended June 29, 2002, June 30, 2001 and June 24, 2000 would have been approximately ($1,680,000), ($0.42) and ($0.42), $6,000, $0.00 and $0.00, and ($2,497,000), ($0.63) and ($0.63), respectively.

A summary of the Company's stock option activity, and related information for the years ended June 29, 2002, June 30, 2001 and June 24, 2000, is as follows:

	# of Options	Weighted Average Exercise Price
Outstanding June 26, 1999	1,547,186	$ 2.56
Granted	240,709	4.06
Exercised	138,000	2.00
Forfeited	307,696	3.66
Outstanding June 24, 2000	1,342,199	$ 2.63
Granted	360,657	2.47
Exercised	--	--
Forfeited	106,135	4.30
Outstanding June 30, 2001	1,596,721	$ 2.48
Granted	754,750	0.55
Exercised	--	--
Forfeited	583,966	1.65
Outstanding June 29, 2002	1,767,505	$ 1.93
Exercisable at June 29, 2002	1,244,044	$ 2.23

NOTE N - STOCK BASED COMPENSATION (Continued)

The weighted-average fair value of options granted during the years ended June 29, 2002, June 30, 2001 and June 24, 2000 was $0.40, $1.36 and $2.84, respectively.

Exercise prices for options outstanding as of June 29, 2002 ranged from $0.54 to $5.25. The weighted average remaining contractual life of these options is as follows:

Exercise Price	# of Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life
$0.54 - $0.55	341,500	$0.55	9.33
$1.50 - $3.01	1,289,839	$1.96	1.96
$5.00 - $5.25	136,166	$5.10	6.56

NOTE O - SIGNIFICANT CUSTOMERS

The Company entered into three multi-year manufacturing agreements each covering a specific operating location with a significant customer, which provide for, among other things, minimum purchase commitments. The agreements were for initial terms expiring during 2001 through 2003 and automatically continue in effect from year to year for successive one year renewal terms unless cancelled in writing by either party at least 180 days prior to the expiration date. The contract with the Indiana facility will expire in March 2003 and the Company has been given notice of non-renewal. The Indiana facility accounted for approximately $25,900,000 in net revenues for the year ended June 29, 2002.

The contracts with the Alabama and Illinois facilities were not renewed and the facilities were closed in October 2001 and May 2002, respectively. The Alabama and Illinois facilities accounted for approximately $1,300,000 and $12,800,000, respectively in net revenues for the year ended June 29, 2002.

Sales to this significant customer represented approximately 86%, 86% and 83% of net sales for the years ended June 29, 2002, June 30, 2001 and June 24, 2000, respectively. At June 29, 2002 and June 30, 2001, two customers accounted for approximately 91% and 88% of trade accounts receivable, respectively, with the above significant customer accounting for approximately 81% and 78%, respectively.

NOTE P - PENSION AND PROFIT SHARING PLAN

The Company has a salary reduction / profit-sharing plan under the provisions of Section 401(k) of the Internal Revenue Code. The Plan covers all full-time employees who have completed one year of service with the Company. The Company's contributions to the plan are made at the discretion of the board of directors and amounted to approximately $50,000 and $40,000 for the years ended June 30, 2001 and June 24, 2000, respectively. The Company made no contribution for the year ended June 29, 2002.

NOTE Q - CONTINGENCY

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 formerly leased to the Company in Jessup, Maryland. Management believes the claim is without merit and intends to vigorously contest the claim. The outcome of the action as well as the extent of the Company's liability, if any, cannot be determined at this time.

NOTE R - QUARTERLY FINANCIAL INFORMATION (UNAUDITED)

Quarterly financial information for the years ended June 29, 2002 and June 30, 2001 is summarized below (in thousands except per share amounts):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2002				
Net sales	$ 12,960	$ 15,735	$ 8,691	$ 10,414
Gross profit	511	1,214	467	797
Net income (loss)	(480)	278	(469)	(473)
Basic earnings (loss) per common share	(0.12)	0.07	(0.11)	(0.12)
Diluted earnings (loss) per common share	(0.12)	0.07	(0.11)	(0.12)
2001				
Net sales	$ 19,474	$ 21,610	$ 12,374	$ 18,709
Gross profit	1,240	1,603	781	1,508
Net income (loss)	55	256	(104)	96
Basic earnings (loss) per common share	0.01	0.06	(0.03)	0.02
Diluted earnings (loss) per common share	0.01	0.06	(0.03)	0.02

PALLET MANAGEMENT SYSTEMS, INC. AND SUBSIDIARIES

SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS

YEARS ENDED JUNE 29, 2002 (52 WEEKS), JUNE 30, 2001 (53 WEEKS) AND JUNE 24, 2000 (52 WEEKS)

	Balance Beginning of Year	Charged to Costs and Expenses	Deducti
Allowance for doubtful accounts:			
June 29, 2002	$ 156,655	$ 25,000	$ (7
June 30, 2001	$ 100,436	$ 142,134	$ (8
June 24, 2000	$ 5,000	$ 95,436	$

Deferred tax asset valuation allowance:

June 29, 2002	$ 1,297,689	$ 423,691	$
June 30, 2001	$ 1,432,748	$ --	$ 13
June 24, 2000	$ 592,342	$ 840,406	$