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FRANKLIN TELECOMMUNICATIONS CORP  
Form 10-Q  
May 17, 2001

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q  
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QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2001

TRANSITION REPORT PURSUANT TO SECTION 13 OF 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

Commission file number 0-11616

FRANKLIN TELECOMMUNICATIONS CORP.  
(Exact Name of Registrant as Specified in its Charter)

-----  
California  
(State or other jurisdiction of  
incorporation or organization)

95-3733534  
(I.R.S. Employer  
Identification No.)

733 Lakefield Road, Westlake Village, California 91361  
(Address of Principal Executive Offices) (Zip Code)  
Registrant's Telephone Number, Including Area Code: (805) 373-8688

Securities registered pursuant to Section 12(b) of the Act:  
Title of each class Name of each exchange  
-----  
Common stock, American Stock Exchange  
without par value

Securities registered pursuant to Section 12(g) of the Act: None  
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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  No

Indicate the number of shares outstanding of each of the issuer's class of common stock, as of the latest practicable date:

TITLE OF EACH CLASS OF COMMON STOCK OUTSTANDING AT MAY 16, 2001  
-----  
Common Stock, no par value 42,480,796

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Index

Franklin Telecommunications Corp.

Part I. FINANCIAL INFORMATION

Item 1. Financial Statements

Consolidated Balance Sheets -  
March 31, 2001 (Unaudited) and June 30, 2000

Consolidated Statements of Operations (Unaudited) - Three months and  
nine months ended March 31, 2001 and 2000

Consolidated Statements of Cash Flows (Unaudited) - Nine months ended  
March 31, 2001 and 2000

Notes to Consolidated Financial Statements (Unaudited)

Item 2. Management's Discussion and Analysis of Financial  
Condition and Results of Operations

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

Item 2. Changes in Securities

Item 3. Defaults Upon Senior Securities

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

Item 5. Other Information

Item 6. Exhibits and Reports on Form 8-K

Item 1. Financial Statements

FRANKLIN TELECOMMUNICATIONS CORP. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
AS OF MARCH 31, 2001 (UNAUDITED) AND JUNE 30, 2000

MARCH 31,  
2001  
-----  
(UNAUDITED)

ASSETS

Current assets

Cash and cash equivalents .....	\$	200,000
Accounts receivable, less allowance for doubtful accounts of \$69,000 (unaudited) and \$50,000, respectively .....		78,000

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Other receivables .....	48,000
Note receivable (a portion due from a related party) .....	60,000
Inventories (Note 2) .....	1,272,000
Prepaid expenses .....	98,000
	-----
Total current assets .....	1,756,000
	-----
Property and equipment	
Machinery and equipment .....	1,108,000
Furniture and fixtures .....	280,000
Computers and software .....	1,667,000
	-----
	3,055,000
Less accumulated depreciation .....	1,625,000
	-----
Total property and equipment .....	1,430,000
	-----
Other assets .....	438,000
	-----
Total assets .....	\$ 3,624,000
	=====

LIABILITIES AND SHAREHOLDERS' EQUITY

Current liabilities	
Current portion of capital lease obligations .....	\$ 28,000
Convertible promissory note (due to a related party) (Note 4) .....	100,000
Accounts payable .....	199,000
Accrued liabilities (Note 3) .....	825,000
	-----
Total current liabilities .....	1,152,000
Long-term debt, (majority due to a related party) .....	762,000
Capital lease obligations, net of current portion .....	-0-
	-----
Total liabilities .....	1,914,000
	-----
Contingencies (Note 5)	
Shareholders' equity	
Preferred stock, no par value 10,000,000 shares authorized,	
Convertible Series C -0- (unaudited) and -0- shares issued and outstanding	-0-
Common stock, no par value 90,000,000 shares authorized 42,406,080	
(unaudited) and 34,247,013 shares issued and outstanding .....	35,084,000
Common stock committed, no par value 74,716 (unaudited) and 74,716 shares	
committed but not yet issued .....	82,000
Accumulated deficit .....	(33,456,000)
	-----
Total shareholders' equity .....	1,710,000
	-----
Total liabilities and shareholders' equity .....	\$ 3,624,000
	=====

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

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FRANKLIN TELECOMMUNICATIONS CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS  
FOR THE THREE MONTHS AND NINE MONTHS ENDED MARCH 31, 2001 AND 2000 (UNAUDITED)

	THREE MONTHS ENDED MARCH 31,		NINE MONTHS MARCH
	2001 (UNAUDITED)	2000 (UNAUDITED)	2001 (UNAUDITED)
Sales			
Product .....	\$ 66,000	\$ 223,000	\$ 379,000
Telephone and Internet services .....	126,000	535,000	725,000
Total sales .....	192,000	758,000	1,104,000
Cost of sales			
Product .....	1,064,000	225,000	1,638,000
Telephone and Internet services .....	230,000	1,468,000	942,000
Total cost of sales .....	1,294,000	1,693,000	2,580,000
Gross profit (loss) .....	(1,102,000)	(935,000)	(1,476,000)
Operating expenses			
Research and development expenses .....	245,000	431,000	1,132,000
Impairment of long-lived assets .....	444,000	160,000	444,000
Selling, general, and administrative Expenses .....	605,000	1,274,000	2,973,000
Total operating expenses .....	1,294,000	1,865,000	4,549,000
Loss from operations .....	(2,396,000)	(2,800,000)	(6,025,000)
Other income (expense)			
Interest income .....	---	15,000	15,000
Interest expense .....	---	(65,000)	(2,000)
Loss on disposal of property and equipment	---	---	(3,000)
Other income (expense) .....	9,000	(17,000)	(1,000)
Total other income (expense) .....	9,000	(67,000)	9,000
Net loss .....	\$ (2,387,000)	\$ (2,867,000)	\$ (6,016,000)
Basic and diluted loss per common share .....	\$ (.06)	\$ (.10)	\$ (.15)
Weighted average common shares outstanding used to compute basic and diluted loss per common share .....	42,456,352	30,011,592	39,411,068

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

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FRANKLIN TELECOMMUNICATIONS CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS  
FOR THE NINE MONTHS ENDED MARCH 31, 2001 AND 2000 (UNAUDITED)

	NINE MONTHS ENDED MARCH 31, 2001	2000
	(UNAUDITED)	(UNAUDITED)
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net loss .....	\$ (6,016,000)	\$ (7,7
Adjustments to reconcile net loss to net cash		
Used in operating activities		
Depreciation and amortization .....	565,000	4
Provision for loss on obsolete inventory .....	1,133,000	
Provision for loss on doubtful accounts .....	38,000	
Stock issued for services rendered .....	325,000	1
(Gain) loss on disposal of property and equip .....	(3,000)	
Loss on impairment of note receivable .....	---	1
Loss on impairment of long-lived assets .....	444,000	
Write-off of accounts receivable .....	---	1,5
(Increase) decrease in		
Accounts receivable .....	20,000	
Other receivables .....	(36,000)	
Inventories .....	293,000	(2
Prepaid expenses .....	(18,000)	(
Increase (decrease) in		
Accounts payable .....	(202,000)	1
Accrued liabilities .....	(103,000)	(6
	-----	-----
Net cash used in operating activities .....	(3,560,000)	(6,1
	-----	-----
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchases of property and equipment .....	(75,000)	(6
Disposal of property and equipment .....	---	(
Other assets .....	(3,000)	(
	-----	-----
Net cash used in investing activities .....	(78,000)	(7
	-----	-----
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Proceeds from convertible notes payable .....	100,000	2,5
Proceeds from exercise of stock options and warrants .....	4,000	
Proceeds from sale of common stock .....	2,485,000	9,5
Payments on capital lease obligations .....	(26,000)	
Proceeds from sale of minority stock in consolidated subsidiary .....	---	
	-----	-----
Net cash provided by financing activities .....	2,563,000	12,1
	-----	-----
Net increase (decrease) in cash and equivalents .....	(1,075,000)	5,2
Cash and cash equivalents, beginning of the period .....	1,275,000	1,6
	-----	-----
Cash and cash equivalents, end of the period .....	\$ 200,000	\$ 6,8
	=====	=====

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

2001	2000
(unaudited)	(unau

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Interest paid ..... \$ 2,000 \$  
=====

SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES  
During the nine months ended March 31, 2001, the Company issued 400,000 shares (unaudited) of common stock for services valued at \$325,000 (unaudited).

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

FRANKLIN TELECOMMUNICATIONS CORP. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

NOTE 1--GENERAL AND SUMMARY OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES

BUSINESS AND ORGANIZATION

Franklin Telecommunications Corp. ("Franklin") and its subsidiaries (collectively the "Company") manufacture and distribute data and telephony communications, access and connectivity products for IP Telephony networks, T-1 and X.25 wide-area networks and provide IP Telephony and Internet services through its majority-owned subsidiary, FNet Corp. ("FNet"). The Company's customers are located predominantly in the United States, Canada, Australia, South America and parts of Europe in a wide range of industries including financial services, government, telephone services and manufacturing.

BASIS OF PRESENTATION

The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all normal, recurring adjustments considered necessary for a fair presentation have been included. The financial statements should be read in conjunction with the audited financial statements included in the Company's annual report on Form 10-K for the fiscal year ended June 30, 2000. The results of operations for the nine months ended March 31, 2001 are not necessarily indicative of the results that may be expected for the fiscal year ending June 30, 2001.

PRINCIPLES OF CONSOLIDATION

The accompanying consolidated financial statements include the accounts of Franklin Telecommunications Corp. and its wholly-owned or majority owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

IMPAIRMENT OF LONG-LIVED ASSETS

The Company reviews its long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of the assets to future net cash flows expected to be generated by the assets. If the assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount exceeds the fair value of the assets. During the nine months

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ended March 31, 2000, the Company recognized \$104,000 (unaudited) as an impairment loss related to licenses which the Company is no longer using and \$340,000 (unaudited) as an impairment loss related to FNet discontinuing its satellite telephone network in the Balkan region.

### LOSS PER COMMON SHARE

The Company calculates loss per common share in accordance with Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings per Share." Basic loss per share is computed by dividing the loss available to common shareholders by the weighted-average number of common shares outstanding. Diluted loss per share is computed similar to basic loss per share, except that the denominator is increased to include the number of additional common shares that would have been outstanding if the potential common shares had been issued and if the additional common shares were dilutive. The following potential common shares have been excluded from the computation of diluted net loss per share for all periods presented because the effect would have been anti-dilutive:

	For the Nine Months March 31, 2001
	2001
	(unaudited)
Options outstanding under the Company's stock option plans	1,880,250
Options granted outside the Company's stock option plans	1,630,000
Convertible notes payable	833,333
Warrants issued in conjunction with convertible notes payable	1,000,000
Warrants issued in conjunction with various private placements	5,800,267
Warrants issued as offering costs for convertible notes payable	100,000

### INCOME TAXES

The Company accounts for income taxes under the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement 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. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is required when it is less likely than not that the Company will be able to realize all or a portion of its deferred tax assets.

### NOTE 2--INVENTORIES

Inventories consisted of the following:

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	MARCH 31, 2001	JUNE 30, 2000
	-----	-----
	(UNAUDITED)	
Raw materials.....	\$1,190,000	\$1,314,000
Work in process.....	207,000	222,000
Finished goods.....	(125,000)	1,162,000
	-----	-----
Total.....	\$ 1,272,000	\$ 2,698,000
	=====	=====

NOTE 3--ACCRUED LIABILITIES

Accrued liabilities consisted of the following:

	MARCH 31, 2001	JUNE 30, 2000
	-----	-----
	(UNAUDITED)	
Salaries and related expense	\$ 654,000	\$ 690,000
Customer deposits .....	37,000	80,000
License payable .....	---	100,000
Other accrued liabilities ..	134,000	158,000
	-----	-----
Total .....	\$ 825,000	\$1,028,000
	=====	=====

NOTE 4--CONVERTIBLE PROMISSORY NOTE

During the nine months ended March 31, 2001, the Company issued convertible promissory debt of \$100,000 (unaudited), payable to the Company's Chief Executive Officer, which is convertible at the option of the holder into the Company's common stock. Interest at 6% per annum and principal are due on March 20, 2002. If the note holder elects to convert the debt into common stock, the conversion price for each share will equal \$0.12 per share, which is the fair market value of the Company's common stock at the date of issuance.

NOTE 5--COMMITMENTS AND CONTINGENCIES

Service Agreement

During the nine months ended March 31, 2001, FNet entered into a five-year service agreement with a satellite service provider to operate uplink and downlink earth stations between the United States and the Balkan region. The estimated fee for the project is \$1,236,000 (unaudited).

Litigation

The Company is involved in certain legal proceedings and claims which arise in the normal course of business. Management does not believe that the outcome of these matters will have a material adverse effect on the Company's consolidated financial position or results of operations.

NOTE 6--RECENT SALE OF EQUITY SECURITIES

During the three months ended March 31, 2001, the Company completed the following significant common stock transactions of previously unissued common shares: Issued 200,000 shares (unaudited) of common stock for services valued at \$100,000 (unaudited).

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

OVERVIEW

Franklin Telecommunications Corp. ("Company") designs, manufactures and sells Internet Telephony equipment, also called Voice Over Internet Protocol equipment ("VOIP") and other high speed communications products and subsystems. Our products are marketed through Original Equipment Manufacturers ("OEMs") and distributors, as well as directly to end users. In addition, through our majority-owned subsidiary, FNet Corp. ("FNet"), we provide traditional switched network and Internet Protocol telephony services, and Internet access to businesses and individuals. The Company's customers are located throughout the world in a wide range of industries including financial services, government, telephone services and manufacturing.

The Company offers a suite of Internet Telephony solutions that enable business communications over data networks. From the small office home office (SOHO) to the branch office and headquarters operations of medium to large scale corporations, the Company offers a cost-effective callhandling solution. From the enterprise to the carrier market, the Company offers converged network solutions; managing the connectivity and integration of voice, data, fax and video. Where ever possible, the Company offers a turnkey solution that can be "owned" by its customers. When equipment sales are not in the best interest of a particular customer's business communications solution, the Company plans to provide that solution as a "service" that can be leased. The Company aims to be a leading edge supplier of Internet Telephony solutions as a result of its flexibility in providing on net and off net business communication solutions as customer owned equipment or Franklin provided services on a global basis. The Company's products and services enable connectivity and e-commerce.

The Company is both an equipment supplier and a service provider, offering turn-key business communications solutions to both the carrier and enterprise segments of the Internet Telephony market. The Company produces gateways, gatekeepers and edge servers that provide advanced packet switching solutions that significantly reduce the infrastructure costs associated with communications networks. The Company's products are designed, developed and manufactured by the Company.

In addition to manufactured solutions, the Company maintains a Network Operations Center that provides both "on -net" and "off-net" connectivity for the Company's equipment customers. The Network Operations Center interconnects the Company's customers on a global basis. The Network Operations Center includes Internet access facilities and a Class 4 circuit switch. The center interconnects with three International Record Carriers and is capable of completing a voice call to any phone in the world. The Company plans to offer its equipment and services customers the opportunity to access the circuit switched facilities and to interconnect with each other, using the Company to enable "settlement" between the networks. This interconnection can be either "free" through the Internet, or delivered through private leased lines.

As a result of the Company's expertise in network operations, the Company is also able to provide additional assistance to its customers by offering design, installation and network management services. The company believes that this strategy of combining network operations and equipment design is a significant product differentiation strategy, uniquely positioning the Company. Many of the Company's customers elect to interconnect with the Network Operations center.

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Much like the Internet, the Company is growing with each additional gateway sale.

Forward-looking statements in this Management's Discussion and Analysis of Financial Condition and Results of Operations, including statements regarding the Company's entrance into the Telephone and Internet business, newly introduced products, development of "VOIP" service capabilities over the Internet, net sales, gross profit, operating expenses, other income and expenses, liquidity and cash needs and the Company's plans and strategies are all based on current expectations, and the Company assumes no obligation to update this information. Numerous factors could cause actual results to differ from those described in the forward-looking statements.

As with any line of business, there can be no assurance that the DVG VOIP products will gain widespread market acceptance or be profitable. In addition, there can be no assurance that new hardware products and services developed by others will not render the Company's hardware products and services noncompetitive or obsolete.

### RESULTS OF OPERATIONS

THREE MONTHS ENDED MARCH 31, 2001 COMPARED TO THREE MONTHS ENDED MARCH 31, 2000

NET SALES. Net sales decreased by \$566,000, or 75%, from \$758,000 in the three months ended March 31, 2000 to \$192,000 in the three months ended March 31, 2001. The decrease is due both to a reduction of DVG hardware systems sales and reduced service revenue, primarily from the Balkan operation. The revenue mix for the three months ended March 31, 2001 consisted of 66% Telephone and Internet services revenue and 34% hardware product sales.

GROSS LOSS. Gross loss increased as a percentage of net sales to a gross loss of 574% for the three months ended March 31, 2001, from a gross loss of 123% of net sales for the corresponding period of 2000. The gross loss percentage increase can be primarily attributed to the \$1,133,000 provision for loss on obsolete inventory and secondarily to fixed hardware and service overhead expenses spread over a smaller sales base.

OPERATING EXPENSES. Operating expenses decreased by \$571,000, or 31%, from \$1,865,000 in the three months ended March 31, 2000 to \$1,294,000 in the three months ended March 31, 2001. The decrease was primarily attributable to a reduced number of employees.

OTHER INCOME (EXPENSE). Interest income decreased by \$15,000, or 100%, from \$15,000 in the three months ended March 31, 2000 to \$-0- in the three months ended March 31, 2001, due to reduced cash balances available to earn interest. Interest expense decreased by \$65,000, or 100%, from \$65,000 in the three months ended March 31, 2000 to \$-0- in the three months ended March 31, 2001, due to the repayment of \$2,500,000 in convertible notes payable. Other components of other income (expense) were immaterial and were due to various non operating items.

NINE MONTHS ENDED MARCH 31, 2001 COMPARED TO NINE MONTHS ENDED MARCH 31, 2000

NET SALES. Net sales decreased by \$1,315,000, or 54%, from \$2,419,000 in the nine months ended March 31, 2000 to \$1,104,000 in the nine months ended March 31, 2001. The decrease is due both to a reduction of DVG hardware systems sales and reduced service revenue, primarily from the Balkan operation. The revenue mix for the nine months ended March 31, 2001 consisted of 68% Telephone

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and Internet services revenue and 32% hardware product sales.

**GROSS LOSS.** Gross loss increased as a percentage of net sales to a gross loss of 134% for the three months ended March 31, 2001, from a gross loss of 47% of net sales for the corresponding period of 2000. The gross loss percentage increase can be primarily attributed to the \$1,133,000 provision for loss on obsolete inventory and secondarily to fixed hardware and service overhead expenses spread over a smaller sales base.

**OPERATING EXPENSES.** Operating expenses decreased by \$2,018,000, or 31%, from \$6,567,000 in the nine months ended March 31, 2000 to \$4,549,000 in the nine months ended March 31, 2001. The primary reason for the decrease was due to a one time increase in the allowance for doubtful accounts of \$1,284,000 during the nine months ended March 31, 2000 for the receivable of a major customer and to a reduced number of employees in the nine months ended March 31, 2001.

**OTHER INCOME (EXPENSE).** Interest income decreased by \$14,000, or 48%, from \$29,000 in the nine months ended March 31, 2000 to \$15,000 in the nine months ended March 31, 2001, due to reduced cash balances available to earn interest. Interest expense decreased by \$64,000, or 97%, from \$66,000 in the nine months ended March 31, 2000 to \$2,000 in the nine months ended March 31, 2001, due primarily to the repayment of \$2,500,000 in convertible notes payable. Other components of other income (expense) were immaterial and were due to various non operating items.

### LIQUIDITY AND CAPITAL RESOURCES

Cash and cash equivalents and net working capital totaled \$200,000 and \$604,000, respectively, as of March 31, 2001. The primary source of cash has been net proceeds generated from equity and debt financings. The Company has relied on sales of new shares, loan proceeds and the exercise of warrants and options to fund operations for an extended period of time. The Company received \$10,589,000 and \$2,485,000 in equity financing for the year ended June 30, 2000, and the nine months ended March 31, 2001, respectively. Its subsidiary, FNet, raised \$53,000 for the year ended June 30, 2000 and \$-0- for the nine months ended March 31, 2001. The Company and its subsidiary FNet have continued to experience losses due to low sales results.

The Company anticipates that its primary uses of working capital in future periods will be for product development, marketing and general working capital.

The Company believes that existing cash and cash equivalents, cash flow from operations and cash raised through future anticipated private placements will be sufficient to meet the Company's presently anticipated working capital needs. The Company is currently having difficulty raising additional capital due to the low trading price of its common shares. If the Company is unable to obtain sufficient private placement financing, it may be unable to continue as a going concern. There can be no assurance that such capital will be available on acceptable terms.

### PART II. OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

Not applicable

#### ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

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Not applicable

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable

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

Not applicable

ITEM 5. OTHER INFORMATION

Not applicable

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

None

(b) Reports on Form 8-K

None

SIGNATURES

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

FRANKLIN TELECOMMUNICATIONS CORP.

By /s/ FRANK W. PETERS

-----  
Frank W. Peters  
Chief Executive Officer

Dated: May 17, 2001