
**UNITED STATES
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 January 3, 2004

OR

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

For the transition period from _____ to _____
Commission file number 0-27559

Textron Financial Corporation

(Exact Name of Registrant as Specified in Its Charter)

Delaware **05-6008768**
(State or Other Jurisdiction of (I.R.S. Employer
Incorporation or Organization) Identification No.)

40 Westminster Street, P.O. Box 6687, Providence, R.I. 02940-6687
(401) 621-4200

(Address of Principal Executive Offices)

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of Class</u>	<u>Name of Each Exchange on Which Registered</u>
\$600,000,000 7½% Notes due December 9, 2004	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act:

<u>Title of Class</u>	<u>Name of Each Exchange on Which Registered</u>
10% Series A Trust Preferred Securities of Subsidiary Trust (and subsidiary guarantee with respect thereto)	NASDAQ

Common Stock, \$100.00 par value

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 by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained herein, and will not be contained, to the best of 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. (Not applicable).

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2.) Yes No

All of the shares of common stock of the registrant are owned by Textron Inc. and there was no voting or non-voting common equity held by non-affiliates as of the last business day of the registrant's most recently completed fiscal quarter.

REGISTRANT MEETS THE CONDITIONS SET FORTH IN GENERAL INSTRUCTION I (1)(a) AND (b) OF FORM 10-K AND IS THEREFORE FILING THIS FORM WITH THE REDUCED DISCLOSURE FORMAT.

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PART I.

Item 1. *Business*

General

Textron Financial Corporation (Textron Financial or the Company) is a diversified commercial finance company with core operations in six segments. Aircraft Finance provides financing for new and used Cessna business jets and piston-engine airplanes, Bell helicopters, and other general aviation aircraft; Asset-Based Lending provides asset-based loans to smaller middle-market companies that manufacture or distribute finished goods, and provides factoring arrangements for freight companies and utility service providers; Distribution Finance offers inventory finance programs for dealers of Textron manufactured products and for dealers of a variety of other household, housing, leisure, agricultural and technology products; Golf Finance makes mortgage loans for the acquisition and refinancing of golf courses and provides term financing for E-Z-GO golf cars and Jacobsen turf-care equipment; Resort Finance extends loans to developers of vacation interval resorts, secured primarily by notes receivable and interval inventory; and Structured Capital engages in tax-oriented, long-term leases of large-ticket equipment and real estate, primarily with investment grade lessees. Textron Financial Corporation's other financial services and products include transaction syndication, equipment appraisal and disposition, and portfolio servicing. Some of these ancillary services are offered through Asset Control LLC and TBS Business Services, Inc.

All of Textron Financial's stock is owned by Textron Inc. (Textron), a \$10 billion global multi-industry company with operations in five business segments: Bell, Cessna, Fastening Systems, Industrial and Finance. At January 3, 2004, 24% of Textron Financial's total managed finance receivables were related to the financing of Textron's products (captive receivables). For further information on Textron Financial's relationship with Textron, see "Relationship with Textron" below.

Textron Financial's financing activities are confined almost exclusively to secured lending and leasing to commercial markets. Textron Financial Corporation's services are offered primarily in North America. However, Textron Financial Corporation finances Textron products worldwide, principally Bell helicopters and Cessna aircraft.

Textron Financial also maintains an Other segment that includes non-core assets related to franchise finance and media finance, and other liquidating portfolios from product lines that were discontinued in 2001. The Company ceased new finance receivable originations in these business markets, and continues to actively manage the accounts to maximize value as the accounts run-off or are sold.

Consistent with the Company's strategy to exit these non-core businesses, Textron Financial sold its small business direct portfolio (small business finance) in December 2003. The following discussion of portfolio quality in Item 1, the selected financial data in Item 6 and the discussion of the Company's results in Item 7 exclude the results of this discontinued operation, as defined by SFAS No. 144, Accounting for the Impairment or Disposal of Long-lived Assets, which is described in Note 4 to the consolidated financial statements in Item 8 of this Form 10-K.

For additional information regarding Textron Financial's business segments, refer to Note 21 to the consolidated financial statements in Item 8 of this Form 10-K.

Competition

The commercial finance environment in which Textron Financial operates is highly fragmented and extremely competitive. Textron Financial Corporation is subject to competition from various types of financing institutions, including banks, leasing companies, insurance companies, commercial finance companies and finance operations of equipment vendors. Competition within the commercial finance industry is primarily focused on price, terms, structure and service. The Company may lose market share to the extent that it is unwilling to match competitors' practices. To the extent that Textron Financial matches these practices, the Company may experience decreased margins, increased risk of credit losses or both. Many of Textron Financial's competitors are large companies that have substantial capital, technological and marketing

resources. This has become increasingly the case given the consolidation activity in the commercial finance industry. In some instances, Textron Financial's competitors have access to capital at a lower cost than Textron Financial.

Relationship with Textron

General

Textron Financial derives a portion of its business from financing the sale and lease of products manufactured and sold by Textron. In 2003, 2002 and 2001, Textron Financial paid Textron \$0.8 billion, \$1.1 billion and \$1.3 billion, respectively, for the sale of manufactured products to third parties that were financed by the Company. In addition, the Company paid Textron \$56.3 million in 2003, \$104.3 million in 2002 and \$62.1 million in 2001 for the purchase of operating lease equipment. Textron Financial recognized finance charge revenues from Textron and affiliates (net of payments or reimbursements for interest charged at more or less than market rates on Textron manufactured products) of \$6.3 million in 2003, \$9.4 million in 2002, and \$4.0 million in 2001, and operating lease revenues of \$22.4 million in 2003, \$21.0 million in 2002, and \$10.9 million in 2001.

Textron Financial and Textron utilize an intercompany account for the allocation of Textron overhead charges and for the settlement of captive receivables. For additional information regarding the relationship between Textron Financial and Textron, see Notes 5, 6, and 11 to the consolidated financial statements in Item 8 of this Form 10-K.

Agreements with Textron

Textron Financial and Textron are parties to several agreements, which govern many areas of the Textron Financial-Textron relationship. They are described below:

Receivables Purchase Agreement

Under a Receivables Purchase Agreement with Textron, Textron Financial has recourse to Textron with respect to certain finance receivables and operating leases relating to products manufactured and sold by Textron. Finance receivables of \$427.5 million at January 3, 2004 and \$526.7 million at December 28, 2002, and operating leases of \$126.3 million at January 3, 2004, and \$122.3 million at December 28, 2002, were subject to recourse to Textron or due from Textron. In addition, Textron Financial had recourse to Textron on seller certificates of \$26.2 million and \$59.2 million at year-end 2003 and 2002, respectively, and on cash reserve accounts of \$4.0 million and \$10.4 million at year-end 2003 and 2002, respectively. Both the seller certificates and the cash reserve accounts are retained interests related to finance receivable securitizations.

Support Agreement with Textron

Under a Support Agreement with Textron dated as of May 25, 1994, Textron is required to pay to Textron Financial, quarterly, an amount sufficient to provide that Textron Financial's pre-tax earnings, before extraordinary items and fixed charges (including interest on indebtedness and amortization of debt discount "fixed charges"), will not be less than 125% of the Company's fixed charges. No such payments under the Support Agreement were required for the years ended 2003, 2002 or 2001, when Textron Financial's fixed-charge coverage ratios (as defined) were 167%, 164%, and 173%, respectively. Textron also has agreed to maintain Textron Financial's consolidated shareholder's equity at an amount no less than \$200 million. Pursuant to the terms of the Support Agreement, Textron is required to directly or indirectly own 100% of Textron Financial's common stock. The Support Agreement also contains a third-party beneficiary provision entitling Textron Financial's lenders to enforce its provisions against Textron.

Tax Sharing Agreement with Textron

Textron Financial's revenues and expenses are included in the consolidated federal tax return of Textron. The Company files some of its state income tax returns on a separate basis. Under a Tax Sharing Agreement

with Textron, Textron Financial is allocated federal tax benefits and charges on the basis of statutory U.S. tax rates applied to the Company's taxable income or loss included in the consolidated returns. The benefits of general business credits, foreign tax credits and any other tax credits are utilized in computing current tax liability. Textron Financial is paid for tax benefits generated and utilized in Textron's consolidated federal and unitary/combined state income tax returns, whether or not the Company would have been able to utilize those benefits on a separate tax return. Income tax assets or liabilities are settled on a quarterly basis. Textron has agreed to loan Textron Financial, on a junior subordinated interest-free basis, an amount equal to Textron's deferred income tax liability attributable to the manufacturing profit not yet recognized for tax purposes on products manufactured by Textron and financed by Textron Financial. Borrowings under this arrangement are reflected in "Amounts due to Textron Inc." on the Consolidated Balance Sheets in Item 8 of this Form 10-K.

Regulations

Textron Financial's activities are subject, in certain instances, to supervision and regulation by state and federal governmental authorities. These activities also may be subject to various laws, including consumer finance laws in some instances, and judicial and administrative decisions imposing various requirements and restrictions, which, among other things:

- Regulate credit-granting activities;
- Establish maximum interest rates, finance charges and other charges;
- Require disclosures to customers;
- Govern secured transactions;
- Affect insurance brokerage activities; and
- Set collection, foreclosure, repossession and claims handling procedures and other trade practices.

Although most states do not intensively regulate commercial finance activity, many states impose limitations on interest rates and other charges, and prohibit certain collection and recovery practices. They also may require licensing of certain business activities and specific disclosure of certain contract terms. The Company also may be subject to regulation in those foreign countries in which it has operations.

Existing statutes and regulations have not had a material adverse effect on the Company's business. However, it is not possible to forecast the nature of future legislation, regulations, judicial decisions, orders or interpretations or their impact upon Textron Financial's future business, financial condition, results of operations or prospects.

Employees

As of January 3, 2004, Textron Financial had 1,287 employees. The Company is not subject to any collective bargaining agreements.

Risk Management

Textron Financial's business activities involve various elements of risk. The Company considers the principal types of risk to be:

- Credit risk;
- Asset/liability risk (including interest rate and foreign exchange risk); and
- Liquidity risk.

Proper management of these risks is essential to maintaining profitability. Accordingly, the Company has designed risk management systems and procedures to identify and quantify these risks. Textron Financial has established appropriate policies and set prudent limits in these areas. The Company's management of these

risks, and levels of compliance with its policies and limits, is continuously monitored by means of administrative and information systems.

Credit Risk Management

Textron Financial manages credit risk through:

- Underwriting procedures;
- Centralized approval of individual transactions exceeding certain size limits; and
- Active portfolio and account management.

The Company has developed underwriting procedures for each operating unit that assess a prospective customer's ability to perform in accordance with financing terms. These procedures include:

- Analyzing business or property cash flows and collateral values;
- Performing financial sensitivity analyses; and
- Assessing potential exit strategies.

Textron Financial has developed a tiered credit approval system, which allows certain transaction types and sizes to be approved at the operating unit level. The delegation of credit authority is done under strict policy guidelines. Textron Financial's operating units are also subject to annual internal audits by the Company and Textron.

Depending on transaction size and complexity, transactions outside of operating unit authority require the approval of a Group President and Group Credit Officer or Corporate Risk Management Officer. Transactions exceeding group authority require one or more of the Executive Vice President and Chief Credit Officer, the President and Chief Operating Officer, Textron Financial's Credit Committee, or the Chairman and Chief Executive Officer depending on the size of the transaction, and in some cases approvals are required by Textron up to and including its Board of Directors. Textron Financial's Credit Committee is comprised of its President and Chief Operating Officer, Executive Vice President and Chief Credit Officer, Executive Vice President and Chief Financial Officer, Executive Vice President, General Counsel and Secretary, President of the Capital Markets Group, and President of Distribution Finance.

The Company controls the credit risk associated with its portfolio by limiting transaction sizes, as well as diversifying transactions by industry, geographic area, property type and borrower. Through these practices, Textron Financial identifies and limits exposure to unfavorable risks and seeks favorable financing opportunities. Management reviews receivable aging trends and watch list reports and conducts regular business reviews in order to monitor portfolio performance. Certain receivable transactions are originated with the intent of fully or partially selling them. This strategy provides an additional tool to manage credit risk.

Geographic Concentration

Textron Financial continuously monitors its portfolio to avoid any undue geographic concentration in any region of the U.S. or in any foreign country. The largest concentration of domestic receivables was in the Southeastern U.S., representing 26% of Textron Financial's total managed finance receivable portfolio at January 3, 2004. International receivables are generated mostly in support of Textron product sales. At January 3, 2004, international receivables represented 13% of Textron Financial's managed finance receivable portfolio, with the largest country, Brazil, representing 3%.

Asset/Liability Risk Management

The Company continuously measures and quantifies interest rate risk, foreign exchange risk and liquidity risk, in each case taking into account the effect of hedging activity. Textron Financial uses derivatives as an integral part of its asset/liability management program in order to reduce:

- Interest rate exposure arising from changes in interest rates; and
- Foreign currency exposure arising from changes in exchange rates.

The Company does not use derivative financial instruments for the purpose of generating earnings from changes in market conditions. Before entering into a derivative transaction, the Company determines that there is a high correlation between the change in value of, or the cash flows associated with, the hedged asset or liability and the value of, or the cash flows associated with, the derivative instrument. When Textron Financial executes a transaction, it designates the derivative to a specific asset or liability, and as either a fair value or cash flow hedge. Textron Financial monitors the effectiveness of derivatives, on a quarterly basis, through a review of the amounts and maturities of assets, liabilities and derivative positions. The Company's Senior Vice President and Treasurer, and Executive Vice President and Chief Financial Officer regularly review this information, so that appropriate remedial action can be taken, as necessary.

Textron Financial carefully manages exposure to counterparty risk in connection with its derivatives. In general, the Company engages in transactions with counterparties having ratings of at least A by Standard & Poor's Rating Service or A2 by Moody's Investors Service. Total notional exposure is monitored by counterparty, and managed within prudent limits. At January 3, 2004, the Company's largest single counterparty credit exposure was \$15 million.

Interest Rate Risk Management

Textron Financial manages interest rate risk by monitoring the duration and interest rate sensitivities of its assets, and by incurring liabilities (either directly or synthetically with derivatives) having a similar duration and interest sensitivity profile. The Company's internal policies limit the aggregate mismatch of floating rate assets and liabilities to 10% of total assets.

Foreign Exchange Risk Management

A small portion of finance assets owned by Textron Financial are located outside of the United States. These receivables are generally in support of Textron's overseas product sales and are predominantly denominated in U.S. Dollars. Textron Financial presently has foreign currency receivables principally denominated in Canadian Dollars and Australian Dollars. In order to minimize the effect of fluctuations in foreign currency exchange rates on the Company's financial results, Textron Financial borrows in these currencies and/or enters into forward exchange contracts, on a monthly basis, in amounts sufficient to hedge its non-functional currency exposures.

Liquidity Risk Management

The Company uses cash to fund asset growth and to meet debt obligations and other commitments. Textron Financial's primary sources of funds are:

- Cash from operations;
- Commercial paper borrowings;
- Issuances of medium-term notes and other term debt securities; and
- Syndication and securitization of receivables.

All commercial paper borrowings are fully backed by committed bank lines of credit, providing liquidity in the event of capital market dislocation. If Textron Financial is unable to access these markets on acceptable terms, the Company can draw on its bank line of credit facilities and use cash flows from operations and

portfolio liquidations to satisfy its liquidity needs. For additional information regarding Textron Financial's liquidity risk management, see "Management's Discussion and Analysis of Financial Condition and Results of Operations — Liquidity and Capital Resources," in Item 7 of this Form 10-K.

Portfolio Quality

The following table presents information about the credit quality of the Company's portfolio:

	<u>2003</u>	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>
	<i>(Dollars in millions)</i>				
Nonperforming assets					
Nonaccrual finance receivables	\$151.9	\$177.3	\$110.0	\$101.9	\$ 83.6
Real estate owned	2.2	25.3	7.4	1.7	8.5
Repossessed assets	7.9	10.9	13.2	7.6	8.8
Total nonperforming assets	<u>\$162.0</u>	<u>\$213.5</u>	<u>\$130.6</u>	<u>\$111.2</u>	<u>\$100.9</u>
Ratio of nonperforming assets to total finance assets	2.8%	3.4%	2.2%	1.9%	1.7%
Delinquency					
60+ days contractual delinquency as a percentage of finance receivables	2.4%	2.9%	2.2%	1.2%	1.0%
Allowance for losses on receivables					
Allowance for losses on receivables	\$119.1	\$144.9	\$124.6	\$116.0	\$112.8
Ratio of allowance for losses on receivables to receivables	2.3%	2.6%	2.4%	2.1%	2.0%
Ratio of allowance for losses on receivables to nonaccrual loans	78.4%	81.7%	113.2%	113.8%	135.0%
Ratio of allowance for losses on receivables to net charge-offs	1.0x	1.4x	2.0x	3.1x	4.8x

Nonperforming Assets

Nonperforming assets include nonaccrual finance receivables and repossessed assets. Textron Financial classifies receivables as nonaccrual and suspends the recognition of earnings when accounts are contractually delinquent by more than three months, unless collection of principal and interest is not doubtful. In addition, earlier suspension may occur if Textron Financial has significant doubt about the ability of the obligor to meet current contractual terms. Doubt may be created by payment delinquency, reduction in the obligor's cash flows, deterioration in the loan to collateral value relationship or other relevant considerations.

Delinquent Earning Accounts and Loan Modifications

Textron Financial does not have any earning accounts that are contractually delinquent by more than three months with the exception of the captive receivables described above. Loans that are modified are not returned to accruing status until six months of timely payments have been received or Textron Financial otherwise deems that full collection of principal and interest is not doubtful.

Allowance for Losses on Receivables

Management evaluates its allowance for losses on receivables based on a combination of factors. For its homogeneous loan pools, Textron Financial examines current delinquencies, the characteristics of the existing accounts, historical loss experience, the value of the underlying collateral and general economic conditions and trends. Textron Financial estimates losses will range from 0.5% to 4.0% of finance receivables depending on the specific homogeneous loan pool. For larger balance commercial loans, Textron Financial considers borrower specific information, industry trends and estimated discounted cash flows, as well as the factors described above for homogeneous loan pools.

Provisions for losses on finance receivables are charged to income, in amounts sufficient to maintain the allowance for losses on receivables at a level considered adequate to cover losses in the existing finance receivable portfolio, based on management's evaluation and analysis of this portfolio.

Finance receivables are charged off when they are deemed uncollectible. Finance receivables are written down to the fair value (less estimated costs to sell) of the related collateral at the earlier of the date the collateral is repossessed or when no payment has been received for six months, unless management deems the receivable collectible.

Loan Impairment

Textron Financial periodically evaluates finance receivables, excluding homogeneous loan portfolios and finance leases, for impairment. A loan is considered impaired when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impairment is measured by comparing the fair value of a loan to its carrying amount. Fair value is based on the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or, if the loan is collateral dependent, at the fair value of the collateral. If the fair value of the loan is less than its carrying amount, the Company establishes a reserve based on this difference. This evaluation is inherently subjective, as it requires estimates, including the amount and timing of future cash flows expected to be received on impaired loans, that may differ from actual results.

Item 2. *Properties*

Textron Financial leases office space from a Textron affiliate for its corporate headquarters at 40 Westminster Street, Providence, Rhode Island 02903. The Company leases other offices throughout North America. For additional information regarding Textron Financial's lease obligations, see Note 18 to the consolidated financial statements in Item 8 of this Form 10-K.

Item 3. *Legal Proceedings*

There are pending or threatened lawsuits and other proceedings against Textron Financial and its subsidiaries. Some of these suits and proceedings seek compensatory, treble or punitive damages in substantial amounts. These suits and proceedings are being defended by, or contested on behalf of, Textron Financial and its subsidiaries. On the basis of information presently available, Textron Financial believes any such liability would not have a material effect on Textron Financial's financial position or results of operations.

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

Omitted per Instruction I of Form 10-K.

PART II.

Item 5. *Market for Registrant's Common Equity and Related Stockholder Matters*

The common stock of Textron Financial is owned entirely by Textron and, therefore, there is no trading of Textron Financial's stock. Dividends of \$114.0 million, \$62.0 million and \$51.1 million were declared and paid in 2003, 2002, and 2001, respectively. For additional information regarding restrictions as to dividend availability, see Note 11 to the consolidated financial statements in Item 8 of this Form 10-K.

Item 6. Selected Financial Data

The following data has been recast to reflect discontinued operations and should be read in conjunction with Textron Financial's consolidated financial statements in Item 8 of this Form 10-K.

	At or for the years ended(1)				
	2003	2002	2001	2000	1999
	<i>(Dollars in thousands)</i>				
Results of Operations					
Finance charges and discounts	\$403,850	\$412,692	\$ 499,758	\$ 587,444	\$ 391,091
Rental revenues on operating leases	28,560	27,147	18,884	18,904	15,503
Other income	139,472	144,291	162,285	84,173	56,309
Income from continuing operations	78,840	76,452	119,541	118,016	78,904
Cumulative effect of change in accounting principle, net of tax benefit	—	15,372	—	—	—
Income (loss) from discontinued operations, net of income taxes	1,545	(774)	1,030	—	—
Balance Sheet Data					
Total finance receivables	\$5,135,247	\$5,534,160	\$5,251,972	\$5,589,412	\$5,577,374
Allowance for losses on receivables	119,148	144,907	124,585	115,953	112,769
Equipment on operating leases — net	210,182	255,055	201,060	135,356	133,171
Total assets	6,332,843	6,654,328	6,463,958	6,130,796	5,989,483
Deferred income taxes	389,653	398,199	357,324	315,322	307,035
Short-term debt	519,632	916,352	1,197,707	965,802	1,339,021
Long-term debt	3,887,334	3,923,269	3,500,713	3,701,067	3,211,737
Textron Financial and Litchfield obligated mandatory redeemable preferred securities of trust subsidiary holding solely Litchfield junior subordinated debentures	26,421	26,950	27,480	28,009	28,539
Shareholder's equity	1,009,163	1,020,817	1,009,355	909,677	869,161
Debt to tangible shareholder's equity(2)	5.24x	5.59x	5.62x	6.72x	6.92x
SELECTED DATA AND RATIOS					
Profitability					
Net interest margin as a percentage of average net investment(3)	6.92%	6.89%	7.48%	6.17%	6.11%
Return on average equity(4)	7.86%	7.59%	12.66%	13.12%	14.06%
Return on average assets(5)	1.25%	1.18%	1.91%	1.88%	1.74%
Selling and administrative expenses as a percentage of average managed and serviced finance receivables(6)	1.98%	1.71%	1.77%	1.67%	1.75%
Operating efficiency ratio(7)	46.77%	39.75%	36.40%	34.10%	35.42%
Credit Quality					
60+ days contractual delinquency as a percentage of finance receivables(8)	2.39%	2.86%	2.26%	1.16%	0.96%
Nonperforming assets as a percentage of finance assets(9)	2.80%	3.41%	2.21%	1.86%	1.74%
Allowance for losses on receivables as a percentage of finance receivables	2.32%	2.62%	2.37%	2.07%	2.02%
Net charge-offs as a percentage of average finance receivables(10)	2.08%	1.83%	1.09%	0.65%	0.54%

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- (1) Textron Financial's year-end dates conform with Textron's year-end, which falls on the nearest Saturday to December 31.
 - (2) Tangible shareholder's equity equals Shareholder's equity, excluding Accumulated other comprehensive income or loss, less Goodwill.
 - (3) Represents revenues earned less interest expense on borrowings and operating lease depreciation as a percentage of average net investment. Average net investment includes finance receivables plus operating leases, less deferred taxes on leveraged leases.
 - (4) Return on average equity excludes the cumulative effect of change in accounting principle.
 - (5) Return on average assets excludes the cumulative effect of change in accounting principle.
 - (6) Average managed and serviced finance receivables include owned receivables, receivables serviced under securitizations, participations and third-party portfolio servicing agreements.
 - (7) Operating efficiency ratio is selling and administrative expenses divided by net interest margin.
 - (8) Delinquency excludes captive receivables with recourse to Textron. Captive receivables represent third-party finance receivables originated in connection with the sale or lease of Textron manufactured products. Percentages are expressed as a function of total Textron Financial independent and nonrecourse captive receivables.
 - (9) Finance assets include: finance receivables; equipment on operating leases, net of accumulated depreciation; repossessed assets and properties; retained interests in securitizations; interest-only securities; investment in equipment residuals; ADC arrangements; and short and long-term investments (some of which are classified in Other assets on Textron Financial's Consolidated Balance Sheets). Nonperforming assets include independent and nonrecourse captive finance assets.
 - (10) Excludes net charge-offs recorded against the real estate owned valuation allowance of \$8.0 million in 2000.

Item 7. *Management's Discussion and Analysis of Financial Condition and Results of Operations*

Overview

Information regarding general information and characteristics of Textron Financial is included in Item 1, Business, of this Form 10-K.

Textron Financial is in the business of originating and servicing commercial finance receivables for Textron-related products and other commercial markets. The principal factors that influence our earnings are the amount and mix of different types of finance receivables, fees earned related to these finance receivables and services, and the credit quality of these finance receivables over time. For finance receivables, net interest margin equals the difference between revenue earned on finance receivables, including fee income, and the cost of borrowed funds. For operating leases, net interest margin equals revenue earned on operating leases, less depreciation expense and the cost of borrowed funds. On certain types of finance receivables, interest rates earned are fixed at the time the contracts are originated, while other types are based on floating rates that are generally tied to changes in the prime rate offered by major U.S. banks or the London Interbank Offered Rate (LIBOR). Rental charges on operating leases may be fixed at the time the contracts are originated or based on floating rates that are generally tied to changes in LIBOR.

Textron Financial borrows funds at various maturities at both fixed and floating interest rates to match the interest sensitivities and maturities of its finance receivables. External market conditions and our debt ratings affect these interest rates. The Company also may, from time to time, enter into interest rate exchange agreements related to new debt issuances in an effort to access the debt markets in the most efficient manner available at the time of issuance. As an alternative source of funding, Textron Financial sells finance receivables in securitizations, retaining an interest in the sold receivables and continuing to service such receivables for a fee.

The Company assesses business performance on an owned basis, managed basis and a serviced basis. The owned basis includes only the finance receivables owned and reported on the consolidated balance sheet. The managed basis includes owned finance receivables and finance receivables sold in securitizations and private transactions, where the Company has retained some element of credit risk, and continues to service the accounts. The serviced basis includes managed receivables and serviced-only receivables, which generally consist of finance receivables of resort developers and other third-party financial institutions without retained credit risk.

Textron Financial retains subordinated interests in finance receivables sold in securitizations and recourse obligations on certain private portfolio sales resulting in credit risk. As a result, the Company evaluates finance receivables and leverage on a managed as well as owned basis. In contrast, the Company does not have a retained financial interest or credit risk in the performance of the serviced portfolio and, therefore, performance of these portfolios is limited to billing and collection activities.

Key Business Initiatives and Trends

During 2003, Textron Financial experienced improvements in portfolio quality and renewed its focus on growing core businesses. While the collectibility of the Company's finance receivable portfolio remains one of the Company's most significant business risks, the improved portfolio quality measures in 2003 demonstrate the Company's successful efforts to resolve problem accounts. The provision for losses declined 27% in 2003 as compared to 2002 due to improving portfolio quality and, to a lesser extent, declining portfolio growth. The Company continued to make steady progress liquidating non-core assets. The Company also implemented steps to streamline the organization through the consolidation of operations in each of two core segments.

During the third quarter of 2002, Textron Financial made a strategic decision to exit franchise finance, media finance, small business finance and other discontinued product lines, and initiated a plan to sell or liquidate approximately \$1.7 billion of non-core assets related to these businesses. The Company also realigned the remaining business units into six operating segments based on the markets served and the products offered: Aircraft Finance, Asset-Based Lending, Distribution Finance, Golf Finance, Resort Finance and Structured Capital. The Company has ceased originating new business in the non-core areas and continues to actively manage the non-core accounts to maximize value. At January 3, 2004, non-core managed finance assets were \$748 million.

Operating efficiency (the ratio of Selling and administrative expenses divided by Net interest margin) has deteriorated over the past two years, as a consequence of higher legal and collection expenses related to nonperforming accounts and the inability to rapidly reduce infrastructure costs in response to slower growth. The Company has taken certain actions to reverse this trend, including restructuring operations and initiatives related to the improvement of information systems and processes. In the fourth quarter of 2003, the Company initiated a restructuring plan to consolidate operations within its corporate headquarters and within each of two core segments: Asset-Based Lending and Resort Finance. As part of the restructuring plan, two facilities were closed and 85 employees terminated. Severance and other costs of \$6.3 million related to the restructuring plan were identified in plans approved by senior management and were recorded at year-end. The Company expects to see modest improvement in the near term, with a targeted operating efficiency ratio of less than 40%.

Financial Condition

Liquidity and Capital Resources

Textron Financial mitigates liquidity risk (i.e., the risk that the Company will be unable to fund maturing liabilities or the origination of new finance receivables) by developing and preserving reliable sources of capital. The Company uses a variety of financial resources to meet these capital needs. Cash is provided from finance receivable sales and collections, and from many types of borrowings, including the issuance of commercial paper and term debt in the public and private markets, as well as finance receivable securitizations. This diversity of capital resources enhances the Company's funding flexibility, limits dependence on any one source of funds, and results in cost-effective funding. In making particular funding decisions, management

considers market conditions, prevailing interest rates and credit spreads, and the maturity profile of its assets and liabilities.

In general, the funding environment for commercial finance companies was difficult in 2002. A weak corporate bond market, combined with a downgrade of the Company's debt credit ratings, increased the Company's unsecured borrowing spreads substantially. Despite these adverse conditions, the Company issued \$2.0 billion of term debt. The Company also utilized a revolving securitization conduit for its Distribution Finance business to expand its short-term funding alternatives.

During 2003, the Company's credit spreads recovered substantially in light of a much stronger corporate bond market and Textron Financial's improving credit profile. Term debt of approximately \$1.2 billion was issued throughout the year at increasingly narrower credit spreads. By year-end, credit spreads had recovered to historically low levels not experienced since 2001.

As part of its commercial paper program, the Company has a policy of maintaining unused committed bank lines of credit in an amount not less than outstanding commercial paper balances. These lines of credit have recently been well in excess of outstanding commercial paper levels, with coverage of 302% and 183% at year-end 2003 and 2002, respectively. These lines of credit currently total \$1.5 billion, of which \$500 million expires in 2004 and \$1.0 billion expires in 2008. The \$500 million facility includes a one-year term out option, effectively extending its expiration into 2005. In addition, during the third quarter of 2003, Textron amended its credit facilities to permit Textron Financial to borrow under those facilities. None of these lines of credit were used at January 3, 2004, or December 28, 2002. Textron Financial also maintains a CAD 50 million committed facility, under which it can borrow an additional CAD 50 million on an uncommitted basis. At January 3, 2004, Textron Financial had used CAD 20 million of the committed portion of the facility. Textron Financial also has a \$25 million multi-currency facility, of which \$17 million remained unused at January 3, 2004. Both the Canadian and multi-currency facilities expire in 2004. Lines of credit not reserved as support for outstanding commercial paper or letters of credit were \$966 million at January 3, 2004, compared to \$716 million at December 28, 2002.

During the third quarter of 2003, Textron Financial filed a shelf registration statement with the Securities and Exchange Commission enabling the Company to issue public debt securities in one or more offerings up to a total maximum offering of \$4 billion. Under this facility, Textron Financial issued \$372 million of term notes during 2003, primarily in U.S. and Canadian markets. The proceeds from these issuances were used to refinance maturing commercial paper and long-term debt. Under a shelf registration statement previously filed with the Securities and Exchange Commission, Textron Financial issued \$816 million of term notes during the first half of 2003.

The following table contains projected primary cash outflows and inflows for the specified periods:

	Payments/Receipts due by Period				Total
	Less than 1 year	2 – 3 years	4 – 5 years <i>(In millions)</i>	Thereafter	
Contractual Obligations					
Primary outflows:					
Commercial paper and other short-term debt, net of cash	\$ 163	—	—	—	\$ 163
Term debt	1,181	\$1,390	\$ 819	\$ 497	3,887
Obligated mandatory redeemable preferred securities	—	—	—	26	26
Operating lease rental payments	5	6	4	4	19
Total contractual payments	1,349	1,396	823	527	4,095
Primary inflows:					
Finance receivables(1)	1,611	1,108	1,154	1,262	5,135
Operating lease rental receipts	25	34	18	15	92
Total contractual receipts	1,636	1,142	1,172	1,277	5,227
Net cash inflow (outflow) (2)	<u>\$ 287</u>	<u>\$ (254)</u>	<u>\$ 349</u>	<u>\$ 750</u>	<u>\$1,132</u>
Cumulative net cash inflow	\$ 287	\$ 33	\$ 382	\$1,132	

(1) Based on contractual cash flows; amount could differ due to prepayments, chargeoffs and other factors.

(2) Excludes finance charges and discounts from receivables, debt interest payments, proceeds from sale of operating lease equipment and other items.

As shown in the preceding table, cash collections from finance assets are expected to be sufficient to cover maturing debt and other contractual liabilities throughout the next five years and thereafter.

At January 3, 2004, Textron Financial had unused commitments to fund new and existing customers under \$1.1 billion of committed revolving lines of credit as compared to \$1.5 billion of committed revolving lines of credit at December 28, 2002. The decrease was largely related to the continued liquidation of the non-core syndicated bank loan portfolio in 2003. Additionally, since many of the agreements will not be used to the extent committed or will expire unused, the total commitment amount does not necessarily represent future cash requirements.

At January 3, 2004, Textron Financial's credit ratings were as follows: Standard & Poor's (A— long-term, A2 short-term, outlook stable), Moody's Investors Service (A3 long-term, P2 short-term, outlook negative) and Fitch (A— long-term, F2 short-term, outlook negative).

During the first quarter of 2003, Textron Financial's commercial paper and long-term debt credit ratings were downgraded from F1 to F2 and from A to A—, respectively, by Fitch. In the second quarter of 2003, Standard & Poor's affirmed the Company's long-term debt rating at A— and upgraded the outlook from negative to stable. Further downgrades in Textron Financial's ratings could increase borrowing spreads or limit its access to the commercial paper, securitization and term debt markets.

Cash provided by operating activities of continuing operations totaled \$242 million in 2003, \$206 million in 2002 and \$266 million in 2001. The increase in the cash provided in 2003 and the decrease in 2002 were primarily due to the timing of payments of accrued interest and other liabilities, principally income taxes payable of \$82 million and the remittance cash received on serviced receivables of \$25 million for 2003.

Cash provided (used) by investing activities of continuing operations totaled \$273 million in 2003, \$(499) million in 2002 and \$(390) million in 2001. These cash flows largely resulted from the origination, purchase, repayment and sales, including securitizations, of finance receivables. The 2003 increase was primarily the result of a \$389 million increase in finance receivable repayments relative to new finance

receivable originations and \$196 million of higher proceeds from receivable sales. The decrease in 2002 was the result of a higher level of new finance receivable originations relative to finance receivable repayments and sales of \$(455) million, mostly offset by a \$(388) million business acquisition in 2001.

Cash provided (used) by financing activities of continuing operations totaled \$(355) million in 2003, \$270 million in 2002 and \$115 million in 2001. The cash used in 2003 mostly relates to the pay down of commercial paper and other short-term debt at year-end from the proceeds received from receivable sales in the fourth quarter. The \$270 million of cash provided in 2002 was mostly used to fund finance asset growth. In addition, the Company issued \$2.0 billion of term debt in 2002 to refinance maturing term debt and repay a 2001 advance of \$510 million from Textron. In 2001, the Company's term debt issuances of \$0.9 billion were used to refinance maturing commercial paper and term debt.

Net cash provided (used) by discontinued operations represents the small business finance operation and totaled \$175 million in 2003, \$27 million in 2002 and \$21 million in 2001.

Because the finance business involves the purchase and carrying of receivables, a relatively high ratio of borrowings to net worth is customary. Debt as a percentage of total capitalization was 81% at January 3, 2004, compared to 83% at December 28, 2002. Textron Financial's ratio of earnings to fixed charges was 1.67x in 2003 (1.64x in 2002 and 1.73x in 2001). Commercial paper and Other short-term debt as a percentage of total debt was 12% at January 3, 2004, compared to 19% at the end of 2002.

In 2003, Textron Financial declared and paid dividends to Textron of \$114.0 million, compared to dividends declared and paid of \$62.0 million in 2002. The increase in 2003 was due to excess capital that resulted from slower than anticipated receivable growth and the return of capital to Textron associated with the sale of small business finance. Textron contributed capital of \$9.0 million to Textron Financial in both 2003 and 2002, which consisted of Textron's dividend on the preferred stock of Textron Funding Corporation.

Off-Balance Sheet Arrangements

Textron Financial sells finance receivables utilizing both securitizations and whole-loan sales. As a result of these transactions, finance receivables are removed from the Company's balance sheet and the proceeds received are used to reduce the Company's recorded debt levels. Despite the reduction in the recorded balance sheet position, the Company generally retains a subordinated interest in the finance receivables sold through securitizations, which may affect operating results through periodic fair value adjustments. The Company also sells receivables in whole-loan sales in which it retains a continuing interest, through limited credit enhancement, in the form of a contingent liability related to finance receivable credit losses and, to a lesser extent, prepayment risk.

The Company utilizes off-balance sheet financing arrangements (primarily asset-backed securitizations) to further diversify the Company's funding alternatives. These arrangements are an important source of funding that provided net proceeds from continuing operations of \$765 million and \$707 million in 2003 and 2002, respectively. Textron Financial has used the proceeds from these arrangements to fund the origination of new finance receivables in the Distribution Finance, Aircraft Finance, Resort Finance and golf equipment businesses, and to retire commercial paper. Gains related to these transactions amounted to \$47 million and \$45 million in 2003 and 2002, respectively. Cash collections on current and prior period securitization gains were \$46 million and \$36 million for 2003 and 2002, respectively.

Termination of the Company's off-balance sheet financing arrangements would significantly reduce the Company's short-term funding alternatives. While these arrangements do not contain provisions that require Textron Financial to repurchase significant balances of receivables previously sold, there are risks that could reduce the availability of these funding alternatives in the future. Potential barriers to the continued use of these arrangements include deterioration in finance receivable portfolio quality, downgrades in the Company's debt credit ratings and a reduction of new finance receivable originations in the businesses that utilize these funding arrangements. Textron Financial does not expect any of these factors to have a material impact on the Company's liquidity or income from continuing operations.

The retained subordinate interests related to the Company's off-balance sheet financing arrangements are typically in the form of interest-only securities, seller certificates, cash reserve accounts and servicing rights and obligations. These interests are typically subordinate to other investors' interests in the off-balance sheet structure and therefore, realization of these interests by the Company is dependent on repayment of other investors' interests and ultimately, the performance of the finance receivables sold. The retained subordinate interests act as credit enhancement to the other investors and represent a deferral of proceeds received from the sale of finance receivables. As a result, the retention of these subordinate interests expose the Company to a level of risk substantially consistent with that of ownership of these finance receivables. Textron Financial does not provide legal recourse to investors that purchase interests in Textron Financial's securitizations beyond the credit enhancement inherent in the retained subordinate interests.

Following the initial sale, and on an ongoing basis, the retained subordinate interests are maintained at fair value in Other assets on the Company's consolidated balance sheets. The Company estimates fair values based on the present value of future cash flows expected under management's best estimates of key assumptions – credit losses, prepayment speeds, forward interest rate yield curves and discount rates commensurate with the risks involved. Management's best assumptions used to record the initial gain on sale and measure the continuing fair value of the retained interests, along with the impact of changes in these assumptions are described in Note 7 to the consolidated financial statements in Item 8 of this Form 10-K.

Whole-loan finance receivable sales, in which the Company maintains a continuing interest, differ from securitizations as loans are sold directly to investors and no portion of the sale proceeds is deferred. Limited credit enhancement is typically provided for these transactions in the form of a contingent liability related to finance receivable credit losses and, to a lesser extent, prepayment risk. Textron Financial has a contingent liability related to the sale of equipment lease rents in 2003 and 2001. The maximum liability at January 3, 2004, was \$45 million, and in the event Textron Financial's credit rating falls below BBB, the Company is required to pledge a related pool of equipment residuals that amount to \$103 million. The Company has valued this contingent liability based on assumptions for annual credit losses and prepayment rates of 0.25% and 7.5%, respectively. An instantaneous 20% adverse change in these rates would have a \$0.3 million impact on the valuation of this recourse liability.

Managed Finance Assets

Managed finance assets consist of owned finance assets, and finance receivables that Textron Financial has sold in securitizations or similar structures and continues to service. Finance assets include finance receivables, equipment on operating leases — net of accumulated depreciation, repossessed assets and properties, retained interests in securitizations, interest-only securities, investment on equipment residuals, ADC arrangements, and other long-term investments (some of which are classified in Other assets in Textron Financial's Consolidated Balance Sheets). The managed finance assets of our business segments are presented in the following table.

	<u>January 3, 2004</u>		<u>December 28, 2002</u>		<u>Increase/ (Decrease)</u>
	<i>(Dollars in thousands)</i>				
Distribution Finance	\$1,987,299	24.3%	\$1,699,993	19.6%	\$ 287,306
Aircraft Finance	1,914,147	23.4%	2,077,967	23.9%	(163,820)
Golf Finance	1,293,917	15.8%	1,398,841	16.1%	(104,924)
Resort Finance	1,134,951	13.9%	1,326,311	15.3%	(191,360)
Structured Capital	634,308	7.8%	581,207	6.7%	53,101
Asset-Based Lending	467,759	5.7%	521,067	6.0%	(53,308)
Other Segment	747,744	9.1%	1,080,383	12.4%	(332,639)
Total managed finance assets	<u>\$8,180,125</u>	<u>100.0%</u>	<u>\$8,685,769</u>	<u>100.0%</u>	<u>\$(505,644)</u>

The decrease in finance assets within the Other segment reflects the sales of franchise finance receivables of \$168 million, prepayments within the syndicated bank loan portfolio of \$42 million and the continued runoff

of the liquidating portfolios. Overall, managed finance assets within the core business decreased \$173 million. The decrease was the result of lower growth and continued portfolio run-off related to the land finance portfolio within Resort Finance, lower operating lease assets and lower volume in Aircraft Finance, and lower volume and higher portfolio run-off in the golf equipment portfolio. These decreases were partially offset by growth in the private brands portfolio within Distribution Finance.

Nonperforming Assets

Nonperforming assets include nonaccrual finance receivables and repossessed assets. Textron Financial classifies receivables as nonaccrual and suspends the recognition of earnings when accounts are contractually delinquent by more than three months, unless collection of principal and interest is not doubtful. In addition, earlier suspension may occur if Textron Financial has significant doubt about the ability of the obligor to meet current contractual terms. Doubt may be created by payment delinquency, reduction in the obligor's cash flows, deterioration in the loan to collateral value relationship or other relevant considerations.

The following table sets forth certain information about nonperforming assets and the related percentages of owned finance assets at 2003, 2002 and 2001 by business segment.

	<u>2003</u>		<u>2002</u>		<u>2001</u>	
			<i>(Dollars in millions)</i>			
Resort Finance	\$ 55.1	5.15%	\$ 44.9	4.27%	\$ 10.0	0.98%
Aircraft Finance	25.6	2.21%	34.4	2.83%	13.1	1.05%
Golf Finance	21.5	2.43%	15.2	1.57%	7.0	0.83%
Distribution Finance	11.2	1.35%	20.6	2.45%	13.8	2.78%
Asset-Based Lending	5.8	1.25%	12.9	2.47%	21.4	3.90%
Other	<u>42.8</u>	5.72%	<u>85.5</u>	7.92%	<u>65.3</u>	5.40%
Total nonperforming assets	<u>\$162.0</u>	2.80%	<u>\$213.5</u>	3.41%	<u>\$130.6</u>	2.21%

In general, the Company believes that nonperforming assets will generally be in the range of 2% to 4% of finance assets depending on economic conditions. After peaking in March 2003, the Company has experienced steady improvement in total nonperforming assets with a \$51.5 million decrease year over year at January 3, 2004. The decrease in 2003 was largely attributable to the Other segment with reductions in liquidating equipment portfolios (\$22.7 million), franchise finance (\$8.3 million), media finance (\$6.5 million) and telecommunications (\$4.6 million). In the core businesses, Distribution Finance declined (\$9.4 million) mostly due to the liquidation of portfolios purchased at a discount. The Company also experienced improvements in Asset-Based Lending (\$7.1 million) and Aircraft Finance (\$8.8 million). Aircraft values have historically tracked well with the business cycles of the U.S. economy, although the effects typically lag changes in the business cycles by about six months. The Company believes that 2002 was the low point of the current cycle and witnessed improvements in 2003. Textron Financial expects that as the economy continues to improve, aircraft values will follow the trend.

The increase in Resort Finance (\$10.2 million) was largely the result of increases in the land finance portfolio (\$7.4 million). Nonperforming assets of Resort Finance related to its portfolio of loans to developers of vacation interval resorts were \$39.6 million (4.7%) at year-end 2003 as compared to \$36.7 million (4.3%) at year-end 2002. While the level of nonperforming assets for the portfolio of loans to developers of vacation interval resorts is relatively unchanged, there has been a shift in nonperforming assets to high-end, fractional shares from the more common weekly vacation ownership interval product. The Golf Finance segment also experienced an increase in nonperforming assets for both the golf course and golf equipment finance portfolios in 2003. The increases were partially attributable to the weaker general economic conditions that resulted in fewer golf rounds played in both 2003 and 2002, a decline in corporate sponsored events in the golf industry and increased competition among golf properties. The Other segment continues to comprise a disproportionate amount of the Company's nonperforming assets accounting for 26% of total nonperforming assets, yet comprising only 13% of the total finance assets at January 3, 2004. Overall, the Company expects continued

modest improvement as these portfolios runoff. However, the Company could realize a temporary, out-of-trend result in any one quarter.

The preceding nonperforming assets table does not include captive receivables with recourse to Textron. Captive receivables with recourse that were 90 days or more delinquent amounted to \$69 million, \$85 million and \$90 million at the years ended 2003, 2002 and 2001, respectively. Revenues recognized on these delinquent accounts were \$5.6 million, \$7.4 million and \$9.5 million for the years ended 2003, 2002 and 2001, respectively.

Interest Rate Sensitivity

Textron Financial's mix of fixed and floating rate debt is continuously monitored by management and is adjusted, as necessary, based on evaluations of internal and external factors.

Management's strategy of matching floating rate assets with floating rate liabilities limits Textron Financial's risk to changes in interest rates. This strategy includes the use of interest rate exchange agreements. At January 3, 2004, floating rate assets were equal to floating rate liabilities, after including the impact of \$1.9 billion of interest rate exchange agreements on long-term debt and \$238 million of interest rate exchange agreements on finance receivables. Classified within fixed rate assets are approximately \$1.0 billion of floating rate loans with index rate floors that are on average 163 basis points above the applicable index rate (predominately the prime rate). As a consequence, these assets are classified as fixed rate, and will remain so until the prime rate increases above the floor rates. Generally, in periods of a low interest rate environment, the Company has benefited from these interest rate floor agreements. However, during periods of rising interest rates, this benefit will dissipate until such time as the prime rate exceeds the floor rates embedded in these agreements.

Management believes that its asset/liability management policy provides adequate protection against interest rate risks. Increases in interest rates, however, could have an adverse effect on interest margin. Variable rate receivables are generally tied to changes in the prime rate offered by major U.S. banks. Changes in short-term borrowing costs generally precede changes in variable rate receivable yields. Textron Financial assesses its exposure to interest rate changes using an analysis that measures the potential loss in net income, over a twelve-month period, resulting from a hypothetical change in interest rates of 100 basis points across all maturities occurring at the outset of the measurement period (sometimes referred to as a "shock test"). Textron Financial also assumes in its analysis that prospective receivable additions will be match funded, existing portfolios will not prepay and all other relevant factors will remain constant. This shock test model, when applied to Textron Financial's asset and liability position at January 3, 2004, indicates that an increase in interest rates of 100 basis points would have a negative impact on Textron Financial's net income and cash flows of \$2.7 million for the following twelve-month period.

Financial Risk Management

Textron Financial's results are affected by changes in U.S. and, to a lesser extent, foreign interest rates. As part of managing this risk, Textron Financial enters into interest rate exchange agreements. Textron Financial's objective of entering into such agreements is not to speculate for profit, but generally to convert variable rate debt into fixed rate debt and vice versa. The overall objective of Textron Financial's interest rate risk management is to achieve match funding objectives. These agreements do not involve a high degree of complexity or risk. Textron Financial does not trade in interest rate exchange agreements or enter into leveraged interest rate exchange agreements. The net effect of these interest rate exchange agreements decreased interest expense by \$43.0 million, \$19.6 million, and \$1.2 million in 2003, 2002, and 2001, respectively.

Textron Financial manages its foreign currency exposure by funding most foreign currency denominated assets with liabilities in the same currency. The Company may enter into foreign currency exchange agreements to convert foreign currency denominated assets and liabilities into functional currency denominated assets and liabilities. In addition, as part of managing its foreign currency exposure, Textron Financial may enter into foreign currency forward exchange contracts. The objective of such agreements is to manage

any remaining non-functional currency exposures to changes in currency rates. The notional amounts of outstanding foreign currency forward exchange contracts in 2003 and 2002 were nominal.

Critical Accounting Policies

Allowance for Losses on Receivables

Management evaluates its allowance for losses on receivables based on a combination of factors. For its homogeneous loan pools, Textron Financial examines current delinquencies, the characteristics of the existing accounts, historical loss experience, the value of the underlying collateral and general economic conditions and trends. Textron Financial estimates losses will range from 0.5% to 4.0% of finance receivables depending on the specific homogeneous loan pool. The range of estimated losses is consistent with prior periods. For larger balance commercial loans, Textron Financial considers borrower specific information, industry trends and estimated discounted cash flows, as well as the factors described above for homogeneous loan pools.

Provisions for losses on finance receivables are charged to income, in amounts sufficient to maintain the allowance for losses on receivables at a level considered adequate to cover existing losses in the existing finance receivable portfolio, based on management's evaluation and analysis of this portfolio.

Finance receivables are charged off when they are deemed uncollectible. Finance receivables are written down to the fair value (less estimated costs to sell) of the related collateral at the earlier of the date the collateral is repossessed or when no payment has been received for six months, unless management deems the receivable collectible.

Goodwill and Other Intangible Assets

Textron Financial evaluates the recoverability of goodwill and other intangible assets annually in the fourth quarter, or more frequently if events or changes in circumstances, such as declines in interest margin or cash flows or material adverse changes in the business climate, indicate that the carrying value of an asset might be impaired. Textron Financial completed its annual impairment test in the fourth quarter of 2003 using the estimates from its long-term strategic plan. No adjustment was required to the carrying value of goodwill or other intangible assets based on the analysis performed.

Goodwill is considered to be impaired when the net book value of a reporting unit exceeds its estimated fair value. Fair values are primarily established using a discounted cash flow methodology. The determination of discounted cash flows is based on the businesses' strategic plans and long-range planning forecasts. The assumptions relative to interest margin, operating expenses and provision for losses included in the plans are management's best estimates based on current and forecasted market conditions. If different assumptions were used in these plans, the related undiscounted cash flows used in measuring impairment could be different potentially resulting in an impairment charge.

Securitized Transactions

Securitized transactions involve the sale of finance receivables to qualified special purpose trusts. Textron Financial may retain an interest in the assets sold in the form of interest-only securities, seller certificates, cash reserve accounts and servicing rights and obligations. At the time of sale, a gain or loss is recorded based on the difference between the proceeds received and the allocated carrying value of the finance receivables sold. The allocated carrying value is determined based on the relative fair values of the finance receivables sold and the interests retained. As such, the fair value estimate of the retained interests has a direct impact on the gain or loss recorded by the Company. Textron Financial estimates fair value based on the present value of future cash flows expected under management's best estimates of key assumptions — credit losses, prepayment speeds, forward interest rate yield curves and discount rates commensurate with the risks involved. Retained interests are recorded at fair value as a component of Other assets on Textron Financial's Consolidated Balance Sheets.

Textron Financial reviews the fair values of the retained interests quarterly using updated assumptions and compares such amounts with the carrying value of the retained interests. When the carrying value exceeds

the fair value of the retained interests, the Company determines whether the decline in fair value is other than temporary. When the Company determines the value of the decline is other than temporary, it writes down the retained interests to fair value with a corresponding charge to income. When a change in fair value of the Company's retained interests is deemed temporary, the Company records a corresponding credit or charge to Other comprehensive income for any unrealized gains or losses. Refer to Note 7 to the consolidated financial statements in Item 8 of this Form 10-K for a summary of key assumptions used to record initial gains related to the sale of finance receivables through securitizations and to measure the current fair value of the retained interests, along with the sensitivity of the fair values to adverse changes in these assumptions.

Results of Operations

Revenues and Net Interest Margin

A comparison of revenues and net interest margin is set forth in the following table.

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<i>(Dollars in millions)</i>		
Finance charges and discounts	\$403.8	\$412.7	\$499.7
Rental revenues on operating leases	28.6	27.1	18.9
Other income	<u>139.5</u>	<u>144.3</u>	<u>162.3</u>
Total revenues	\$571.9	\$584.1	\$680.9
Interest expense	171.6	185.9	260.5
Depreciation of equipment on operating leases	<u>17.6</u>	<u>13.8</u>	<u>7.8</u>
Net interest margin	<u>\$382.7</u>	<u>\$384.4</u>	<u>\$412.6</u>
Portfolio yield	7.60%	7.68%	9.28%
Net interest margin as a percentage of average net investment	6.92%	6.89%	7.48%

2003 vs. 2002

The decrease in finance charges principally reflects lower average finance receivables, a change in mix between fixed rate and floating rate finance receivables, and, to a lesser extent, a lower interest rate environment. The decrease in other income was mostly due to lower syndication income (\$7.6 million), primarily resulting from a \$9.3 million nonrecurring gain on the sale of a franchise finance portfolio in 2002 and lower investment income (\$5.4 million) from a decrease in earnings on retained securitization assets, partially offset by higher servicing income (\$9.3 million) from the revolving securitization conduit for Distribution Finance receivables. The decrease in interest expense was attributable to a lower interest rate environment and the maturity of higher cost debt. The increase in depreciation of equipment on operating leases reflects higher average operating leases in 2003.

2002 vs. 2001

Finance charges and discounts for 2002 declined 17.4% reflecting lower yields on finance receivables, primarily due to a lower interest rate environment largely reflecting a reduction in the prime rate. Rental revenues on operating leases increased reflecting higher average operating lease assets primarily related to Aircraft Finance. The decrease in other income was primarily due to lower prepayment gains (\$15.0 million), mostly due to a \$14.3 million nonrecurring prepayment gain in 2001, and lower syndication income (\$7.8 million), partially offset by higher servicing income (\$5.9 million), mostly related to a revolving securitization conduit. The decrease in interest expense was mostly due to a lower interest rate environment. The decrease in net interest margin as a percentage of average net investment primarily reflects higher relative borrowing costs and lower other income, partially offset by receivable pricing increases. The Company's relative borrowing costs increased despite a lower interest rate environment, due to an increase in corporate borrowing rates as compared to major borrowing indices, such as three-month LIBOR and U.S. Treasury rates.

Selling and Administrative Expenses

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<i>(Dollars in millions)</i>		
Selling and administrative expenses as a percentage of managed and serviced receivables	1.98%	1.71%	1.77%
Operating efficiency ratio	46.77%	39.75%	36.40%
Selling and administrative expenses	\$178.9	\$152.8	\$150.2

2003 vs. 2002

The increase in 2003 selling and administrative expenses largely resulted from higher legal and collection costs (\$12.2 million), primarily related to the continued resolution of nonperforming accounts and the accrual of settlement costs associated with litigation during the year, refer to Notes 19 and 20 to the consolidated financial statements in Item 8 of this Form 10-K, and higher data processing costs (\$3.6 million) and healthcare (\$3.2 million), and to a lesser extent, growth in average managed and serviced finance receivables (\$2.2 million).

2002 vs. 2001

The increase in selling and administrative expenses for 2002 was mostly due to an increase in legal and collections costs (\$15.4 million) related to the continued resolution of nonperforming accounts, partially offset by a reduction in goodwill amortization of \$12.1 million (reflecting the change in accounting).

Provision for Losses

Allowance for losses on receivables is presented in the following table.

	<u>January 3, 2004</u>	<u>December 28, 2002</u>	<u>December 29, 2001</u>
	<i>(Dollars in millions)</i>		
Allowance for losses on receivables beginning of period	\$144.9	\$124.6	\$116.0
Provision for losses	80.9	111.3	68.9
Less net charge-offs:			
Aircraft Finance	15.7	14.0	8.2
Distribution Finance	18.8	8.5	4.0
Resort Finance	5.6	2.5	0.8
Golf Finance	2.6	1.0	—
Asset-Based Lending	6.2	6.5	13.3
Structured Capital	—	0.2	—
Other	68.3	70.4	35.2
Total net charge-offs	117.2	103.1	61.5
Acquisitions and other	10.5	12.1	1.2
Allowance for losses on receivables end of period	<u>\$119.1</u>	<u>\$144.9</u>	<u>\$124.6</u>
Net charge-offs as a percentage of average finance receivables	2.1%	1.8%	1.1%
Allowance for losses on receivables as a percentage of total finance receivables	2.3%	2.6%	2.4%
Allowance for losses on receivables as a percentage of total finance receivables (excluding captive receivables with recourse to Textron)	2.5%	2.9%	2.7%
Allowance for losses on receivables as a percentage of nonaccrual loans	78.4%	81.7%	113.2%

2003 vs. 2002

The decrease in the 2003 provision for losses primarily reflected a declining rate of portfolio growth and an improvement in portfolio quality as measured by improvements in nonperforming assets and 60+ delinquency. The increase in net charge-offs was primarily attributable to Distribution Finance, reflecting increased portfolio growth and net charge-offs related to portfolios purchased at a discount. The Other segment continued to represent a disproportionate share of the Company's total net charge-offs accounting for 58% of the 2003 net charge-off amount, while comprising only 14% of the owned finance receivables at year-end 2003.

The decrease in the allowance for losses on receivables as a percentage of nonaccrual loans reflects a \$62.5 million decrease in under-collateralized nonaccrual loans with identified reserve requirements of \$47.4 million at January 3, 2004 as compared to \$109.9 million at December 28, 2002.

2002 vs. 2001

The increase in the provision for losses in 2002 reflected declining portfolio quality and the strengthening of the allowance for losses on receivables. The increase in net charge-offs reflected increases primarily in the Other segment, including syndicated bank loans (\$23.1 million), principally related to the telecommunications industry. The Other segment represented a disproportionate share of the Company's total net charge-offs accounting for 68% of the 2002 net charge-off amount, while comprising only 19% of the owned finance receivables at year-end 2002. The increase in Aircraft Finance reflected the down business cycle in the aircraft industry, while the increase in Distribution Finance was largely the result of portfolio growth.

The decrease in the allowance for losses as a percentage of nonaccrual loans was related to an increase in nonaccrual accounts in 2002, supported by strong collateral values.

Although management believes it has made adequate provision for anticipated losses, realization of these assets remains subject to uncertainties. Subsequent evaluations of nonperforming assets, in light of factors then prevailing, including economic conditions, may require additional increases in the allowance for losses for such assets.

Operating Results by Segment

Segment income presented in the tables below represents income from continuing operations before special charges, income taxes, distributions on preferred securities and cumulative effect of change in accounting principle.

Distribution Finance

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<i>(In millions)</i>		
Revenues	\$151.2	\$103.5	\$89.8
Net interest margin	\$132.2	\$ 88.2	\$65.2
Selling and administrative expenses	53.3	37.7	24.2
Provision for losses	<u>21.2</u>	<u>10.8</u>	<u>8.2</u>
Segment income	<u>\$ 57.7</u>	<u>\$ 39.7</u>	<u>\$32.8</u>

The improvement in Distribution Finance segment income in 2003 was driven by a stronger net interest margin, partially offset by higher selling and administrative expenses and higher provision for losses. The higher net interest margin was principally due to higher average finance receivables (\$219 million), the effect of prime rate floors on floating rate receivables and an increase in other income (\$16.2 million) mostly due to increased securitization activity. Segment income in 2002 increased due to higher net interest margin, offset by higher selling and administrative expenses and higher provision for losses related to increased growth. The

higher net interest margin was principally due to higher fee income (\$14.2 million, principally revolving securitization income), higher pricing and higher average finance receivables (\$40 million).

Resort Finance

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<i>(In millions)</i>		
Revenues	\$87.3	\$95.8	\$106.1
Net interest margin	\$60.7	\$71.9	\$ 66.9
Selling and administrative expenses	25.5	18.2	22.0
Provision for losses	<u>9.4</u>	<u>10.9</u>	<u>3.5</u>
Segment income	<u>\$25.8</u>	<u>\$42.8</u>	<u>\$ 41.4</u>

Resort Finance segment income declined in 2003 reflecting lower net interest margin and higher selling and administrative expenses, primarily legal and collections expense, partially offset by lower provision for losses. The decrease in net interest margin reflected lower receivable pricing and lower other income (\$4.5 million), partially offset by higher average finance receivables (\$85 million). The increase in segment income for 2002 reflected higher net interest margin and lower selling and administrative expenses, partially offset by higher provision for losses. The increase in net interest margin was mostly due to increased pricing and higher average finance assets (\$55 million), while selling and administrative expenses decreased due to a reduction in goodwill amortization (reflecting the change in accounting).

Golf Finance

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<i>(In millions)</i>		
Revenues	\$81.3	\$72.4	\$67.7
Net interest margin	\$46.6	\$38.7	\$32.5
Selling and administrative expenses	16.7	13.8	10.3
Provision for losses	<u>2.1</u>	<u>2.7</u>	<u>1.0</u>
Segment income	<u>\$27.8</u>	<u>\$22.2</u>	<u>\$21.2</u>

Golf Finance segment income improved in 2003 principally reflecting an increase in net interest margin from higher other income (\$6.6 million), mostly related to a \$4.1 million gain on the sale of rents related to a golf equipment portfolio. The increase in net interest margin was partially offset by higher selling and administrative expenses related to an expansion of servicing responsibilities related to the captive golf equipment portfolio. Average finance receivables were relatively unchanged. Segment income in 2002 increased reflecting higher interest net margin principally due to higher average finance assets (\$155 million), which was partially offset by higher selling and administrative expenses and higher provision for losses.

Aircraft Finance

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<i>(In millions)</i>		
Revenues	\$80.3	\$93.5	\$124.6
Net interest margin	\$31.9	\$37.8	\$ 63.2
Selling and administrative expenses	13.8	14.3	19.1
Provision for losses	<u>8.2</u>	<u>15.7</u>	<u>9.3</u>
Segment income	<u>\$ 9.9</u>	<u>\$ 7.8</u>	<u>\$ 34.8</u>

Aircraft Finance segment income rose modestly in 2003, largely reflecting a lower provision for losses and lower selling and administrative expenses, partially offset by a lower interest margin. The reduction in net interest margin primarily reflected a decrease in other income (\$4.7 million), mostly securitization gains and investment income, and a decrease in average finance receivables (\$87 million). The decrease in segment income for 2002 largely reflected lower interest margin, despite \$168 million of higher average finance receivables, in addition to a write-down of retained interests in securitized assets (\$11.0 million) reflecting lower expected realization on defaulted assets. Also contributing to lower income was higher provision for losses, partially offset by lower selling and administrative expenses. The lower interest margin in 2002 was due to competitive pressures inhibiting the ability to pass on higher borrowing costs related to an increase in interest rate spreads to benchmark borrowing rates (such as U.S. Treasury rates and LIBOR).

Asset-Based Lending

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<i>(In millions)</i>		
Revenues	\$58.7	\$62.4	\$75.8
Net interest margin	\$48.1	\$49.9	\$53.4
Selling and administrative expenses	26.4	24.1	26.3
Provision for losses	<u>1.9</u>	<u>12.0</u>	<u>3.1</u>
Segment income	<u>\$19.8</u>	<u>\$13.8</u>	<u>\$24.0</u>

Asset-Based Lending segment income increased during 2003 due to a lower provision for losses, reflecting an improvement in portfolio quality, partially offset by higher selling and administrative expenses and a lower interest margin. Lower interest margin was primarily the result of lower average finance receivables (\$33 million). Segment income decreased in 2002 reflecting a higher provision for losses and lower net interest margin due to lower finance receivable pricing on lower average finance assets (\$18 million), partially offset by a decrease in selling and administrative expenses.

Structured Capital

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<i>(In millions)</i>		
Revenues	\$35.1	\$38.2	\$42.5
Net interest margin	\$14.8	\$20.1	\$33.5
Selling and administrative expenses	2.8	2.4	2.3
Provision for losses	<u>—</u>	<u>(2.2)</u>	<u>2.2</u>
Segment income	<u>\$12.0</u>	<u>\$19.9</u>	<u>\$29.0</u>

Structured Capital segment income decreased in 2003 mostly due to lower net interest margin. The decrease in net interest margin was largely the result of lower portfolio yields from new originations and higher allocated money cost. Average finance receivables are relatively unchanged. Income decreased in 2002 by \$9.2 million reflecting lower interest margin, largely due to a nonrecurring prepayment gain of \$14.3 million in 2001.

Other Segment

	<u>2003</u>	<u>2002</u>	<u>2001</u>
		<i>(In millions)</i>	
Revenues	\$ 78.0	\$118.4	\$174.3
Net interest margin	\$ 48.4	\$ 77.9	\$ 97.9
Selling and administrative expenses	40.4	42.2	46.0
Provision for losses	<u>38.1</u>	<u>61.4</u>	<u>41.7</u>
Segment (loss) income	<u>\$(30.1)</u>	<u>\$(25.7)</u>	<u>\$ 10.2</u>

Other segment loss increased in 2003 reflecting lower net interest margin, partially offset by a lower provision for losses and lower selling and administrative expenses. The decrease in net interest margin was partly due to lower other income (\$18.2 million), principally syndication gains from the sale of a franchise finance receivable portfolio in 2002, and the run-off of liquidating portfolios. The decrease in 2002 segment income reflected lower net interest margin and higher provision for losses, primarily due to higher net charge-offs from nonperforming assets in syndicated bank loans (\$23.1 million), principally related to the telecommunication industry, and other liquidating portfolios (\$11.1 million), primarily small-ticket equipment finance.

Income from Continuing Operations

Income from continuing operations of \$78.8 million for 2003 was \$2.4 million or 3.1% higher than 2002. The increase was due to a lower loss provision (\$30.3 million) and a lower effective tax rate (\$4.2 million), partially offset by higher operating expenses (\$26.2 million), an increase in special charges (\$6.3 million) due to the restructuring of operations, and lower interest margin (\$1.7 million).

Income from continuing operations for 2002 was \$43.1 million or 36.1% lower than 2001. The decrease was the result of a higher provision for losses (\$42.4 million), lower interest margin (\$28.2 million) and higher operating expenses (\$2.6 million), partially offset by a decrease in special charges (\$2.6 million) and a lower effective tax rate.

New Accounting Pronouncements

FASB Interpretation No. 46

In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46 (“FIN 46” or the “Interpretation”, “Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51”). The Interpretation requires the consolidation of variable interest entities in which an enterprise absorbs a majority of the entity’s expected losses, receives a majority of the entity’s expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity. Currently, entities are generally consolidated by an enterprise that has a controlling financial interest through ownership of a majority voting interest in the entity. FIN 46 originally was effective immediately for variable interest entities created after January 31, 2003, and effective in the third quarter of Textron Financial’s fiscal 2003 for those created prior to February 1, 2003. Textron Financial has adopted FIN 46 for an agreement that was entered into in June 2003 and determined that the entity was not a variable interest entity.

Subsequent to the original issuance of the Interpretation, the effective date for entities created or interests obtained prior to February 1, 2003 was deferred, and in December 2003, the FASB issued a revised version of FIN 46 that provided clarification of the original Interpretation and excluded certain operating entities from its scope. Public companies are required to apply the provisions of this Interpretation specifically to entities commonly referred to as special-purpose entities (SPE) in financial statements for periods ending after December 15, 2003. The effective date for all other types of entities within the scope of the Interpretation is for financial statements periods ending after March 15, 2004.

Textron Financial will adopt FIN 46 in the first quarter of 2004 for entities created or interests obtained prior to February 2003. The Company has substantially completed the process of evaluating the Interpretation and believes its adoption will not have a material impact on its results of operations or financial position.

FASB Staff Position 150-3

In May 2003, the FASB issued SFAS No. 150 "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity". SFAS No. 150 requires that an issuer classify certain financial instruments as liabilities. Many of the instruments included within the Statement's scope, such as mandatorily redeemable shares, were previously classified as equity. SFAS No. 150 was effective for financial instruments entered into or modified after May 31, 2003, and was effective at the beginning of the first interim period beginning after June 15, 2003 for all other instruments. As required, Textron Financial adopted this Statement when it became effective in July 2003 and reported its obligated mandatorily redeemable preferred securities as a liability and all related expenses prospectively as components of income from continuing operations.

Subsequent to adoption, on November 7, 2003, the FASB issued FASB Staff Position (FSP) 150-3 "Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity". FSP 150-3 deferred the effective date of SFAS No. 150 for certain mandatorily redeemable non-controlling interests. Textron Financial's obligated mandatorily redeemable preferred securities were included in this deferral. FSP 150-3 states that entities that have already adopted SFAS No. 150 for instruments within the scope of its indefinite deferral shall reverse the effects of that adoption in the first fiscal period beginning after the date the FSP was issued. Textron Financial will adopt FSP 150-3 in the first quarter of 2004. Since Textron Financial's mandatorily redeemable preferred securities will be included in the adoption of FIN 46 in the first quarter of 2004, the adoption of FSP 150-3 will have no impact on Textron Financial's results of operations or financial position.

Forward-looking Information

Certain statements in this Annual Report and other oral and written statements made by Textron Financial from time to time are forward-looking statements, including those that discuss strategies, goals, outlook or other nonhistorical matters; or project revenues, income, returns or other financial measures. These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from those contained in the statements, including the following: (a) the extent to which Textron Financial is able to achieve savings from its restructuring plans; (b) uncertainty in estimating the amount and timing of restructuring charges and related costs; (c) changes in worldwide economic and political conditions that impact interest and foreign exchange rates; (d) the occurrence of further downturns in customer markets to which Textron products are sold or supplied and financed or where Textron Financial offers financing; (e) the ability to control costs and successful implementation of various cost reduction programs; (f) the impact of changes in tax legislation; (g) the ability to maintain portfolio credit quality; (h) Textron Financial's access to debt financing at competitive rates; (i) access to equity in the form of retained earnings and capital contributions from Textron; and (j) uncertainty in estimating contingent liabilities and establishing reserves tailored to address such contingencies.

Item 7A. Quantitative and Qualitative Disclosure About Market Risk

For information regarding Textron Financial's Quantitative and Qualitative Disclosure about Market Risk, see "Risk Management" in Item 1 of this Form 10-K.

Item 8. *Financial Statements and Supplementary Data*

REPORT OF INDEPENDENT AUDITORS

The Board of Directors
Textron Financial Corporation

We have audited the accompanying consolidated balance sheets of Textron Financial Corporation as of January 3, 2004 and December 28, 2002, and the related consolidated statements of income, cash flows, and changes in shareholder's equity for each of the three years in the period ended January 3, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the 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 financial statements referred to above present fairly, in all material respects, the consolidated financial position of Textron Financial Corporation at January 3, 2004 and December 28, 2002, and the consolidated results of its operations and its cash flows for each of the three years in the period ended January 3, 2004, in conformity with accounting principles generally accepted in the United States.

Boston, Massachusetts
January 29, 2004

CONSOLIDATED STATEMENTS OF INCOME

For each of the three years in the period ended January 3, 2004

	2003	2002	2001
	<i>(In thousands)</i>		
Finance charges and discounts	\$403,850	\$412,692	\$499,758
Rental revenues on operating leases	28,560	27,147	18,884
Other income	139,472	144,291	162,285
Total revenues	571,882	584,130	680,927
Interest expense	171,565	185,911	260,470
Depreciation of equipment on operating leases	17,617	13,802	7,861
Net interest margin	382,700	384,417	412,596
Selling and administrative	178,936	152,765	150,200
Provision for losses	80,941	111,272	68,904
Special charges	6,309	—	2,686
Income from continuing operations before income taxes and distributions on preferred securities	116,514	120,380	190,806
Income taxes	36,926	42,450	69,830
Distributions on preferred securities (net of tax benefits of \$368, \$762 and \$810, respectively)	748	1,478	1,435
Income from continuing operations	78,840	76,452	119,541
Income (loss) from discontinued operations, net of income taxes	1,545	(774)	1,030
Income before cumulative effect of change in accounting principle	80,385	75,678	120,571
Cumulative effect of change in accounting principle, net of tax benefit	—	15,372	—
Net income	<u>\$ 80,385</u>	<u>\$ 60,306</u>	<u>\$120,571</u>

See notes to consolidated financial statements.

CONSOLIDATED BALANCE SHEETS

	<u>January 3, 2004</u>	<u>December 28, 2002</u>
	<i>(Dollars in thousands)</i>	
Assets		
Cash and equivalents	\$ 357,307	\$ 21,287
Finance receivables, net of unearned income:		
Installment contracts	1,396,466	1,774,482
Revolving loans	1,194,113	1,199,711
Golf course and resort mortgages	944,522	962,459
Distribution finance receivables	777,979	792,323
Leveraged leases	513,227	460,163
Finance leases	<u>308,940</u>	<u>345,022</u>
Total finance receivables	5,135,247	5,534,160
Allowance for losses on receivables	<u>(119,148)</u>	<u>(144,907)</u>
Finance receivables — net	5,016,099	5,389,253
Equipment on operating leases — net	210,182	255,055
Goodwill	169,283	169,283
Other assets	579,972	548,987
Assets of discontinued operations	<u>—</u>	<u>270,463</u>
Total assets	<u><u>\$6,332,843</u></u>	<u><u>\$6,654,328</u></u>
Liabilities and shareholder's equity		
Liabilities		
Accrued interest and other liabilities	\$ 479,115	\$ 345,270
Amounts due to Textron Inc.	21,525	23,471
Deferred income taxes	389,653	398,199
Debt	4,406,966	4,839,621
Textron Financial and Litchfield obligated mandatory redeemable preferred securities of trust subsidiary holding solely Litchfield junior subordinated debentures	<u>26,421</u>	<u>26,950</u>
Total liabilities	<u><u>5,323,680</u></u>	<u><u>5,633,511</u></u>
Shareholder's equity		
Common stock, \$100 par value (4,000 shares authorized; 2,500 shares issued and outstanding)	250	250
Capital surplus	573,676	573,676
Investment in parent company preferred stock	(25,000)	(25,000)
Accumulated other comprehensive loss	(1,676)	(14,637)
Retained earnings	<u>461,913</u>	<u>486,528</u>
Total shareholder's equity	<u><u>1,009,163</u></u>	<u><u>1,020,817</u></u>
Total liabilities and shareholder's equity	<u><u>\$6,332,843</u></u>	<u><u>\$6,654,328</u></u>

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

For each of the three years in the period ended January 3, 2004

	2003	2002	2001
		<i>(In thousands)</i>	
Cash flows from operating activities:			
Income from continuing operations	\$ 78,840	\$ 76,452	\$ 119,541
Adjustments to reconcile income to net cash provided by operating activities:			
Provision for losses	80,941	111,272	68,904
Increase (decrease) in accrued interest and other liabilities	81,784	(33,665)	46,752
Depreciation	33,769	26,924	18,806
Amortization	11,382	10,190	21,828
Leveraged lease noncash earnings	3,795	(3,178)	—
Noncash gains on securitizations	(15,188)	(28,150)	(42,799)
Deferred income tax provision	(28,513)	57,533	46,335
Other	(4,410)	(11,486)	(13,833)
Net cash provided by operating activities of continued operations	242,400	205,892	265,534
Cash flows from investing activities:			
Finance receivables originated or purchased	(9,824,132)	(8,874,305)	(7,456,149)
Finance receivables repaid	8,792,541	7,454,048	5,587,570
Proceeds from receivable sales, including securitizations	1,162,150	965,717	2,018,689
Acquisitions, net of cash acquired	—	—	(387,594)
Other investments	104,755	17,131	(62,581)
Proceeds from disposition of operating leases and other assets	76,905	53,848	13,014
Proceeds from repossessed assets and real estate owned	33,729	7,325	183
Other capital expenditures	(16,746)	(17,016)	(17,317)
Purchase of assets for operating leases	(56,310)	(105,873)	(85,444)
Net cash provided by (used in) investing activities of continued operations	272,892	(499,125)	(389,629)
Cash flows from financing activities:			
Principal payments on long-term debt	(1,310,693)	(1,605,000)	(1,097,226)
Proceeds from issuance of long-term debt	1,236,393	2,022,384	896,872
Net (decrease) increase in commercial paper	(289,815)	330,947	(332,560)
Net (decrease) increase in other short-term debt	(21,179)	(530,500)	564,465
Proceeds from issuance of nonrecourse debt	199,198	169,692	276,118
Principal payments on nonrecourse debt	(62,772)	(58,362)	(200,855)
(Decrease) increase in amounts due to Textron Inc.	(1,334)	(6,514)	9,987
Capital contributions from Textron Inc.	9,010	9,010	49,010
Dividends paid to Textron Inc.	(114,010)	(62,010)	(51,110)
Net cash (used in) provided by financing activities of continued operations	(355,202)	269,647	114,701
Effect of exchange rate changes on cash	637	(658)	—
Net cash provided by (used in) continued operations	160,727	(24,244)	(9,394)
Net cash provided by discontinued operations	175,293	27,042	21,385
Net increase in cash and equivalents	336,020	2,798	11,991
Cash and equivalents at beginning of period	21,287	18,489	6,498
Cash and equivalents at end of period	\$ 357,307	\$ 21,287	\$ 18,489

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDER'S EQUITY

For each of the three years in the period ended January 3, 2004

	Common Stock	Capital Surplus	Investment in Parent Company Preferred Stock	Accumulated Other Comprehensive Loss	Retained Earnings	Total
	<i>(In thousands)</i>					
Balance December 30, 2000	\$250	\$533,676	\$(25,000)	—	\$ 400,751	\$ 909,677
Comprehensive income:						
Net income	—	—	—	—	120,571	120,571
Other comprehensive loss, net of income taxes:						
Unrealized net losses on hedge contracts	—	—	—	\$(19,359)	—	(19,359)
Unrealized net gains on interest-only securities . . .	—	—	—	<u>566</u>	—	<u>566</u>
Other comprehensive income	—	—	—	(18,793)	—	(18,793)
Comprehensive income	—	—	—	—	—	101,778
Capital contributions from						
Textron Inc.	—	49,010	—	—	—	49,010
Dividends to Textron Inc.	<u>—</u>	<u>(9,010)</u>	<u>—</u>	<u>—</u>	<u>(42,100)</u>	<u>(51,110)</u>
Balance December 29, 2001	250	573,676	(25,000)	(18,793)	479,222	1,009,355
Comprehensive income:						
Net income	—	—	—	—	60,306	60,306
Other comprehensive income, net of income taxes:						
Unrealized net gains on interest-only securities . . .	—	—	—	9,601	—	9,601
Unrealized net losses on hedge contracts	—	—	—	(1,893)	—	(1,893)
Foreign currency translation adjustments	—	—	—	<u>(3,552)</u>	—	<u>(3,552)</u>
Other comprehensive income	—	—	—	4,156	—	4,156
Comprehensive income	—	—	—	—	—	64,462
Capital contributions from						
Textron Inc.	—	9,010	—	—	—	9,010
Dividends to Textron Inc.	<u>—</u>	<u>(9,010)</u>	<u>—</u>	<u>—</u>	<u>(53,000)</u>	<u>(62,010)</u>
Balance December 28, 2002	250	573,676	(25,000)	(14,637)	486,528	1,020,817
Comprehensive income:						
Net income	—	—	—	—	80,385	80,385
Other comprehensive income, net of income taxes:						
Unrealized net gains on hedge contracts	—	—	—	14,902	—	14,902
Foreign currency translation adjustments	—	—	—	1,511	—	1,511
Unrealized net losses on interest-only securities . . .	—	—	—	<u>(3,452)</u>	—	<u>(3,452)</u>
Other comprehensive income	—	—	—	12,961	—	12,961
Comprehensive income	—	—	—	—	—	93,346
Capital contributions from						
Textron Inc.	—	9,010	—	—	—	9,010
Dividends to Textron Inc.	<u>—</u>	<u>(9,010)</u>	<u>—</u>	<u>—</u>	<u>(105,000)</u>	<u>(114,010)</u>
Balance January 3, 2004	<u>\$250</u>	<u>\$573,676</u>	<u>\$(25,000)</u>	<u>\$ (1,676)</u>	<u>\$ 461,913</u>	<u>\$1,009,163</u>

See notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 Summary of Significant Accounting Policies

Nature of Operations

Textron Financial Corporation (Textron Financial or the Company) is a diversified commercial finance company with operations in six segments: Aircraft Finance, Asset-Based Lending, Distribution Finance, Golf Finance, Resort Finance and Structured Capital. Aircraft Finance provides financing for new and used Cessna business jets and piston-engine airplanes, Bell helicopters and other general aviation aircraft. Asset-Based Lending provides asset-based loans to smaller middle-market companies that manufacture or distribute finished goods, and factoring arrangements for freight companies and utility service providers. Distribution Finance offers inventory finance programs for dealers of Textron manufactured products and for dealers of a variety of other household, housing, leisure, agricultural and technology products. Golf Finance makes mortgage loans for the acquisition and refinancing of golf courses, and provides term financing for E-Z-GO golf cars and Jacobsen turf-care equipment. Resort Finance extends loans to developers of vacation interval resorts, secured primarily by notes receivable and interval inventory. Structured Capital engages in tax-oriented, long-term leases of large-ticket equipment and real estate, primarily with investment grade lessees. Textron Financial's other financial services and products include transaction syndication, equipment appraisal and disposition, and portfolio servicing.

Textron Financial's financing activities are confined almost exclusively to secured lending and leasing to commercial markets. Textron Financial's services are offered primarily in North America. However, Textron Financial does finance Textron products worldwide, principally Bell helicopters and Cessna aircraft.

Textron Financial is a subsidiary of Textron Inc. (Textron), a \$10 billion multi-industry company with operations in five business segments: Bell, Cessna, Fastening Systems, Industrial and Finance. At January 3, 2004, 24% of Textron Financial's total managed finance receivables involved the financing of Textron's products, compared to 23% at December 28, 2002. Textron Financial's year-end dates conform with Textron's year-end, which falls on the nearest Saturday to December 31.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Textron Financial and its subsidiaries, all of which are wholly-owned. All significant intercompany transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in those statements and accompanying notes. Actual results may differ from such estimates.

Finance Charges and Discounts

Finance charges and discounts include interest on loans, capital lease earnings, leveraged lease earnings and discounts on certain revolving credit and factoring arrangements. Finance charges are recognized in finance charge revenues using the interest method to produce a constant rate of return over the terms of the finance assets. Accrual of interest income is suspended for accounts that are contractually delinquent by more than three months, unless collection is not doubtful. In addition, detailed reviews of loans may result in earlier suspension if collection is doubtful. Cash payments on nonaccrual accounts, including finance charges, generally are applied to reduce loan principal. Accrual of interest is resumed when the loan becomes contractually current, and suspended interest income is recognized at that time.

Finance Receivable Origination Fees and Costs

Fees received and direct loan origination costs are deferred and amortized to finance charge revenues over the contractual lives of the respective receivables using the interest method. Unamortized amounts are recognized in revenues when receivables are sold or paid in full.

Other Income

Other income includes securitization and syndication gains on the sale of loans and leases, late charges, prepayment gains, residual gains, servicing fees and other miscellaneous fees, which are primarily recognized as income when received. It also includes earnings on retained interests in securitizations including interest on seller certificates and cash reserve accounts as well as the accretable yield on interest-only securities.

Allowance for Losses on Receivables

Management evaluates its allowance for losses on receivables based on a combination of factors. For its homogeneous loan pools, Textron Financial examines current delinquencies, the characteristics of the existing accounts, historical loss experience, the value of the underlying collateral and general economic conditions and trends. For larger balance commercial loans, Textron Financial considers borrower specific information, industry trends and estimated discounted cash flows, as well as the factors described above for homogeneous loan pools.

Provisions for losses on finance receivables are charged to income, in amounts sufficient to maintain the allowance for losses on receivables at a level considered adequate to cover losses in the existing finance receivable portfolio, based on management's evaluation and analysis of this portfolio.

Finance receivables are charged off when they are deemed uncollectible. Finance receivables are written down to the fair value (less estimated costs to sell) of the related collateral at the earlier of the date the collateral is repossessed or when no payment has been received for six months, unless management deems the receivable collectible.

Loan Impairment

Textron Financial periodically evaluates finance receivables, excluding homogeneous loan portfolios and finance leases, for impairment. A loan is considered impaired when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impairment is measured by comparing the fair value of a loan to its carrying amount. Fair value is based on the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or, if the loan is collateral dependent, at the fair value of the collateral. If the fair value of the loan is less than its carrying amount, the Company establishes a reserve based on this difference. This evaluation is inherently subjective, as it requires estimates, including the amount and timing of future cash flows expected to be received on impaired loans, that may differ from actual results.

Equipment on Operating Leases

Income from operating leases is recognized in equal amounts over the lease terms. The costs of such assets are capitalized and depreciated to estimated residual values using the straight-line method over the estimated useful life of the asset or the lease term.

Goodwill and Other Intangible Assets

Management evaluates the recoverability of goodwill and other intangibles annually, or more frequently if events or changes in circumstances, such as declines in interest margin, earnings or cash flows or material adverse changes in the business climate, indicate that the carrying value of an asset might be impaired. Goodwill is considered to be impaired when the net book value of a reporting unit exceeds its estimated fair value. Fair values are primarily established using a discounted cash flow methodology. The determination of discounted cash flow is based on the businesses' strategic plans and long-range planning forecasts.

Pension Benefits and Postretirement Benefits Other than Pensions

Textron Financial participates in Textron's defined contribution and defined benefit pension plans. The cost of the defined contribution plan amounted to approximately \$0.6 million, \$2.1 million and \$1.9 million in 2003, 2002 and 2001, respectively. The cost of the defined benefit pension plan amounted to approximately \$6.6 million, \$4.7 million and \$3.4 million in 2003, 2002 and 2001, respectively. Defined benefits under salaried plans are based on salary and years of service. Textron's funding policy is consistent with federal law and regulations. Pension plan assets consist principally of corporate and government bonds and common stocks. Accrued pension expense is included in Accrued interest and other liabilities on Textron Financial's Consolidated Balance Sheets.

Income Taxes

Textron Financial's revenues and expenses are included in Textron's consolidated tax return. Current tax expense is based on allocated federal tax charges and benefits on the basis of statutory U.S. tax rates applied to the Company's taxable income or loss included in Textron's consolidated returns.

Deferred income taxes are recognized for temporary differences between the financial reporting basis and income tax basis of assets and liabilities, based on enacted tax rates expected to be in effect when such amounts are expected to be realized or settled.

Securitized Transactions

Securitized transactions involve the sale of finance receivables to qualified special purpose trusts. Textron Financial may retain an interest in the assets sold in the form of interest-only securities, seller certificates, cash reserve accounts and servicing rights and obligations. The Company's retained interests are subordinate to other investors' interests in the securitizations. Gain or loss on the sale of the loans or leases depends in part on the previous carrying amount of the financial assets involved in the transfer, allocated between the assets sold and the retained interests based on their relative fair values at the date of transfer. Retained interests are recorded at fair value as a component of Other assets on Textron Financial's Consolidated Balance Sheets. The Company estimates fair values based on the present value of future cash flows expected under management's best estimates of key assumptions — credit losses, prepayment speeds and discount rates commensurate with the risks involved.

Textron Financial reviews the fair values of the retained interests quarterly using updated assumptions and compares such amounts with the carrying value of the retained interests. When the carrying value exceeds the fair value of the retained interests, the Company determines whether the decline in fair value is other than temporary. When the Company determines the value of the decline is other than temporary, it writes down the retained interests to fair value with a corresponding charge to income. When a change in fair value of the Company's retained interests is deemed temporary, the Company records a corresponding credit or charge to Other comprehensive income for any unrealized gains or losses.

Textron Financial does not provide legal recourse to third-party investors that purchase interests in Textron Financial's securitizations beyond the credit enhancement inherent in the retained interest-only securities, seller certificates and cash reserve accounts.

Derivative Financial Instruments

Textron Financial has entered into various interest rate and foreign exchange agreements to mitigate its exposure to changes in interest and foreign exchange rates. The Company records all derivative financial instruments on its balance sheet at fair value and recognizes changes in fair values in current earnings unless the derivatives qualify as hedges of future cash flows. For derivatives qualifying as hedges of future cash flows, the Company records the effective portion of the change in fair value as a component of Other comprehensive income in the periods the hedged transaction affects earnings.

Textron Financial recognizes the net interest differential on interest rate exchange agreements, including premiums paid or received, as adjustments to finance income or interest expense to correspond with the

hedged positions. In the event of an early termination of a derivative financial instrument, the Company defers the gain or loss in Other comprehensive income until it recognizes the hedged transaction in earnings.

While these exchange agreements expose Textron Financial to credit losses in the event of nonperformance by the counterparties to the agreements, the Company does not expect any such nonperformance. The Company minimizes the risk of nonperformance by entering into contracts with financially sound counterparties having long-term bond ratings of generally no less than single A, by continuously monitoring such credit ratings and by limiting its exposure with any one financial institution. Textron Financial had minimal exposure to loss from nonperformance by the counterparties to these agreements at the end of 2003.

Fair Value of Financial Instruments

Fair values of financial instruments are based upon estimates at a specific point in time using available market information and appropriate valuation methodologies. These estimates are subjective in nature and involve uncertainties and significant judgment in the interpretation of current market data. Therefore, the fair values presented are not necessarily indicative of amounts Textron Financial could realize or settle currently.

Cash and Equivalents

Cash and equivalents consist of cash in banks and overnight interest-bearing deposits in banks.

Reclassifications

Certain prior year amounts have been reclassified to conform with the current year presentation.

New Accounting Pronouncements

FASB Interpretation No. 46

In January 2003, the Financial Accounting Standards Board (FASB) issued Interpretation No. 46 (“FIN 46” or the “Interpretation”, “Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51”). The Interpretation requires the consolidation of variable interest entities in which an enterprise absorbs a majority of the entity’s expected losses, receives a majority of the entity’s expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity. Currently, entities are generally consolidated by an enterprise that has a controlling financial interest through ownership of a majority voting interest in the entity. FIN 46 originally was effective immediately for variable interest entities created after January 31, 2003, and effective in the third quarter of Textron Financial’s fiscal 2003 for those created prior to February 1, 2003. Textron Financial has adopted FIN 46 for an agreement that was entered into in June 2003 and determined that the entity was not a variable interest entity.

Subsequent to the original issuance of the Interpretation, the effective date for entities created or interests obtained prior to February 1, 2003 was deferred, and in December 2003, the FASB issued a revised version of FIN 46 that provided clarification of the original Interpretation and excluded certain operating entities from its scope. Public companies are required to apply the provisions of this Interpretation specifically to entities commonly referred to as special-purpose entities (SPE) in financial statements for periods ending after December 15, 2003. The effective date for all other types of entities within the scope of the Interpretation is for financial statements periods ending after March 15, 2004.

Textron Financial will adopt FIN 46 in the first quarter of 2004 for entities created or interests obtained prior to February 2003. The Company has substantially completed the process of evaluating the Interpretation and believes its adoption will not have a material impact on its results of operations or financial position.

FASB Staff Position 150-3

In May 2003, the FASB issued SFAS No. 150 “Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity”. SFAS No. 150 requires that an issuer classify certain financial instruments as liabilities. Many of the instruments included within the Statement’s scope, such as mandatorily

redeemable shares, were previously classified as equity. SFAS No. 150 was effective for financial instruments entered into or modified after May 31, 2003, and was effective at the beginning of the first interim period beginning after June 15, 2003 for all other instruments. As required, Textron Financial adopted this Statement when it became effective in July 2003 and reported its obligated mandatorily redeemable preferred securities as a liability and all related expenses prospectively as components of income from continuing operations.

Subsequent to adoption, on November 7, 2003, the FASB issued FASB Staff Position (FSP) 150-3 “Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity”. FSP 150-3 deferred the effective date of SFAS No. 150 for certain mandatorily redeemable non-controlling interests. Textron Financial’s obligated mandatorily redeemable preferred securities were included in this deferral. FSP 150-3 states that entities that have already adopted SFAS No. 150 for instruments within the scope of its indefinite deferral shall reverse the effects of that adoption in the first fiscal period beginning after the date the FSP was issued. Textron Financial will adopt FSP 150-3 in the first quarter of 2004. Since Textron Financial’s mandatorily redeemable preferred securities will be included in the adoption of FIN 46 in the first quarter of 2004, the adoption of FSP 150-3 will have no impact on Textron Financial’s results of operations or financial position.

NOTE 2 Other Income

	<u>2003</u>	<u>2002</u>	<u>2001</u>
		<i>(In thousands)</i>	
Securitization gains	\$ 42,742	\$ 45,403	\$ 42,799
Servicing fees	32,002	22,678	16,780
Prepayment gains	13,967	10,513	25,550
Syndication income	10,092	17,699	25,500
Investment income	9,517	14,925	16,119
Late charges	8,972	8,937	9,590
Other	22,180	24,136	25,947
Total other income	<u>\$139,472</u>	<u>\$144,291</u>	<u>\$162,285</u>

The Other component of Other income includes custodial fees, commitment fees, residual gains, insurance fees and other miscellaneous fees, which are primarily recognized as income when received.

NOTE 3 Special Charges

During the fourth quarter of 2003, the Company’s management performed a strategic review of its operations and committed to a plan to restructure the operations within its corporate headquarters and within each of two core segments — Asset Based Lending and Resort Finance. As a result of the restructuring program, two facilities were closed, 85 employees were terminated and the Company recorded a restructuring charge of \$6.3 million. This charge is summarized below for the applicable segments:

	<u>Severance Costs</u>	<u>Contract Terminations</u>	<u>Fixed Assets Impairments</u>	<u>Other Associated Costs</u>	<u>Total</u>
			<i>(In thousands)</i>		
Asset-Based Lending	\$ 670	\$207	\$ 97	\$ 13	\$ 987
Resort Finance	658	5	1,438	500	2,601
Corporate	<u>2,721</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>2,721</u>
	<u>\$4,049</u>	<u>\$212</u>	<u>\$1,535</u>	<u>\$513</u>	<u>\$6,309</u>

As of January 3, 2004, the Company had paid severance related benefits and other expenses of \$3.7 million, which were charged against the restructuring reserve, leaving a balance in the reserve of

\$2.6 million. The Company will pay the remaining restructuring costs in 2004. The detail of the reserve account is presented below:

	<u>Severance Costs</u>	<u>Contract Terminations</u>	<u>Fixed Assets Impairments</u>	<u>Other Associated Costs</u>	<u>Total</u>
	<i>(In thousands)</i>				
Balance at December 28, 2002	—	—	—	—	—
Additions	\$ 4,049	\$212	\$ 1,535	\$ 513	\$ 6,309
Cash Paid	(1,969)	(21)	—	(153)	(2,143)
Non cash utilization	—	—	(1,535)	—	(1,535)
Balance at January 3, 2004	<u>\$ 2,080</u>	<u>\$191</u>	<u>\$ —</u>	<u>\$ 360</u>	<u>\$ 2,631</u>

In 2001, the Company recorded a restructuring charge of \$2.7 million related to severance costs and contract terminations, which was fully paid out during 2001 and 2002.

NOTE 4 Discontinued Operations

On December 19, 2003, the Company sold its small business direct portfolio (small business finance) for \$421 million in cash and based upon the terms of the transaction no gain or loss was recorded. Textron Financial's Consolidated Financial Statements and related footnotes have been recast to reflect small business finance as a discontinued operation for the periods presented.

The major classes of assets for discontinued operations at December 28, 2002 are presented below.

	<i>(In thousands)</i>
Finance receivables(1)	\$221,490
Allowance for losses on receivables	<u>(21,603)</u>
Finance receivables — net	199,887
Goodwill	11,560
Other assets	<u>59,016</u>
Total assets of discontinued operations	<u>\$270,463</u>

(1) Finance receivables are net of a revolving securitization conduit of \$204 million.

Operating results for discontinued operations are as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<i>(In millions)</i>		
Revenues	\$46,386	\$46,106	\$28,309
Income (loss) from discontinued operations	2,458	(1,227)	1,639
Income taxes	913	(453)	609
Net income (loss) from discontinued operations, net of income taxes	<u>\$ 1,545</u>	<u>\$ (774)</u>	<u>\$ 1,030</u>

NOTE 5 Relationship with Textron Inc.

Textron Financial is a wholly-owned subsidiary of Textron and derives a portion of its business from financing the sale and lease of products manufactured and sold by Textron. Textron Financial recognized finance charge revenues from Textron and affiliates (net of payments or reimbursements for interest charged at more or less than market rates on Textron manufactured products) of \$6.3 million in 2003, \$9.4 million in 2002, and \$4.0 million in 2001, and operating lease revenues of \$22.4 million in 2003, \$21.0 million in 2002, and \$10.9 million in 2001. In 2003, 2002, and 2001, Textron Financial paid Textron \$0.8 billion, \$1.1 billion and \$1.3 billion, respectively, relating to the sale of manufactured products to third parties that were financed

by the Company. In addition, the Company paid Textron \$56.3 million, \$104.3 million and \$62.1 million, respectively, for the purchase of operating lease equipment.

Textron Financial and Textron are parties to several agreements, collectively referred to as operating agreements, which govern many areas of the Textron Financial-Textron relationship. It is the intention of these parties to execute transactions at market terms. Under operating agreements with Textron, Textron Financial has recourse to Textron with respect to certain finance receivables and operating leases. Finance receivables of \$427.5 million at January 3, 2004 and \$526.7 million at December 28, 2002, and operating leases of \$126.3 million at January 3, 2004, and \$122.3 million at December 28, 2002, were subject to recourse to Textron or due from Textron. In addition, Textron Financial had recourse to Textron on seller certificates of \$26.2 million and \$59.2 million at year-end 2003 and 2002, respectively, and on cash reserve accounts of \$4.0 million and \$10.4 million at year-end 2003 and 2002, respectively. Both the seller certificates and the cash reserve accounts are retained interests related to receivable securitizations.

Under the operating agreements between Textron and Textron Financial, Textron has agreed to lend Textron Financial, interest-free, an amount not to exceed the deferred income tax liability of Textron attributable to the manufacturing profit deferred for tax purposes on products manufactured by Textron and financed by Textron Financial. The Company had borrowings from Textron of \$21.4 million at January 3, 2004 (\$23.7 million at December 28, 2002) under this arrangement. These borrowings are reflected in Amounts due to Textron Inc. on Textron Financial's Consolidated Balance Sheets. In addition, Textron has amended its credit agreements to permit Textron Financial to borrow under these facilities. Textron Financial had not utilized those facilities at January 3, 2004.

Textron has also agreed to cause Textron Financial's pretax income available for fixed charges to be no less than 125% of its fixed charges and its consolidated Shareholder's equity to be no less than \$200 million. No related payments were required for 2003, 2002 or 2001.

The Company had income taxes payable of \$79.2 million and \$9.1 million at January 3, 2004 and December 28, 2002, respectively. These accounts are settled with Textron as Textron manages its consolidated federal tax position.

NOTE 6 Finance Receivables

Contractual Maturities

The contractual maturities of finance receivables outstanding at January 3, 2004, were as follows:

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>Thereafter</u>	<u>Total</u>
	<i>(In thousands)</i>						
Installment contracts ..	\$ 280,974	\$174,390	\$148,607	\$147,793	\$170,981	\$ 473,721	\$1,396,466
Revolving loans	349,726	155,976	124,925	219,969	190,614	152,903	1,194,113
Golf course and resort mortgages	129,122	160,838	216,690	156,317	175,189	106,366	944,522
Distribution finance receivables	766,691	11,288	—	—	—	—	777,979
Leveraged leases	16,482	(1,858)	(2,135)	(10,778)	69,637	441,879	513,227
Finance leases	<u>68,242</u>	<u>95,101</u>	<u>23,972</u>	<u>19,306</u>	<u>15,126</u>	<u>87,193</u>	308,940
Total finance receivables	<u>\$1,611,237</u>	<u>\$595,735</u>	<u>\$512,059</u>	<u>\$532,607</u>	<u>\$621,547</u>	<u>\$1,262,062</u>	\$5,135,247

Finance receivables often are repaid or refinanced prior to contractual maturity. Accordingly, the above tabulation should not be regarded as a forecast of future cash collections. The ratio of cash collections (net of finance charges) to average net receivables, excluding distribution finance receivables and revolving loans, was approximately 57% in 2003 and 54% in 2002. During 2003 and 2002, cash collections of finance receivables (excluding proceeds from receivable sales or securitizations) were \$8.8 billion and \$7.5 billion, respectively.

Installment contracts and finance leases have initial terms generally ranging from two to twenty years. Installment contracts and finance leases are secured by the financed equipment and, in some instances, by the personal guarantee of the principals or recourse arrangements with the originating vendor. Finance leases include residual values expected to be realized at contractual maturity.

Revolving loans generally have terms of one to five years, and at times convert to term loans that contractually amortize over an average term of four years. Revolving loans consist of loans secured by trade receivables, inventory, plant and equipment, pools of vacation interval resort notes receivable, pools of residential and recreational land loans and the underlying real property.

Golf course mortgages have initial terms generally ranging from five to seven years with amortization periods from 15 to 25 years. Resort mortgages generally represent construction and inventory loans with terms up to two years. Golf course and resort mortgages are secured by real property and are generally limited to 75% or less of the property's appraised market value at loan origination. Golf course mortgages, totaling \$643.4 million, consist of loans with an average balance of \$4.2 million and an average remaining contractual maturity of four years. Resort mortgages, totaling \$301.1 million, consist of loans with an average balance of \$4.1 million and an average remaining contractual maturity of two years.

Distribution finance receivables generally mature within one year. Distribution finance receivables are secured by the inventory of the financed distributor or dealer and, in some programs, by recourse arrangements with the originating manufacturer. Revolving loans and Distribution finance receivables are cyclical and result in cash turnover that is several times larger than contractual maturities. In 2003, such cash turnover was 9.3 times contractual maturities.

Leveraged leases are secured by the ownership of the leased equipment and real property. Leveraged leases reflect contractual maturities net of contractual nonrecourse debt payments and include residual values expected to be realized at contractual maturity. Leveraged leases have initial terms up to approximately 30 years.

Textron Financial's finance receivables are diversified across geographic region, borrower industry and type of collateral. Textron Financial's geographic concentrations (as measured by managed finance receivables) at January 3, 2004, were as follows: Southeast 26%; Far West 19%; Midwest 15%; Southwest 12%; Mideast 10%; New England 4%; other domestic 1%; South America 4%; and other international 9%. Textron Financial's most significant collateral concentration was general aviation aircraft, which accounted for 22% of managed finance receivables at January 3, 2004. The Company has industry concentrations in the golf and vacation interval industries, which accounted for 15% and 14%, respectively, of managed finance receivables at January 3, 2004. The Company has one account with a balance in excess of one percent of managed finance receivables totaling \$85 million. The Company has full recourse to Textron with respect to this account.

Leveraged Leases

	<u>2003</u>	<u>2002</u>
	<i>(In thousands)</i>	
Rental receivable	\$ 1,651,094	\$ 1,401,832
Nonrecourse debt	(1,153,716)	(1,017,290)
Estimated residual values of leased assets	415,031	398,773
Less unearned income	(399,182)	(323,152)
Investment in leveraged leases	513,227	460,163
Deferred income taxes	(353,005)	(327,523)
Net investment in leveraged leases	<u>\$ 160,222</u>	<u>\$ 132,640</u>

Estimated residual values of leased assets include guaranteed residuals of \$21.8 million and \$2.6 million for 2003 and 2002, respectively. Approximately 39% of Textron Financial's investment in leveraged leases is collateralized by real estate.

The components of income from leveraged leases were as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
		<i>(In thousands)</i>	
Income recognized	\$26,984	\$ 29,491	\$25,586
Income tax expense	(8,365)	(10,027)	(9,237)
Income from leveraged leases	<u>\$18,619</u>	<u>\$ 19,464</u>	<u>\$16,349</u>

Finance Leases

	<u>2003</u>	<u>2002</u>
		<i>(In thousands)</i>
Total minimum lease payments receivable	\$ 287,063	\$ 338,454
Estimated residual values of leased equipment	187,743	189,827
	474,806	528,281
Unearned income	(165,866)	(183,259)
Net investment in finance leases	<u>\$ 308,940</u>	<u>\$ 345,022</u>

Minimum lease payments due under finance leases for each of the next five years and the aggregate amounts due thereafter are as follows: \$51.5 million in 2004, \$29.1 million in 2005, \$20.3 million in 2006, \$15.0 million in 2007, \$9.8 million in 2008 and \$161.4 million thereafter.

Loan Impairment

The Company had \$152.0 million of nonaccrual finance receivables at January 3, 2004, compared to \$177.3 million at December 28, 2002. Nonaccrual finance receivables resulted in Textron Financial's revenues being reduced by approximately \$16.2 million, \$15.9 million and \$10.4 million for 2003, 2002 and 2001, respectively. No interest income was recognized using the cash basis method. Excluding homogeneous loan portfolios and finance leases, the Company had impaired loans of \$98.8 million and \$122.1 million at January 3, 2004 and December 28, 2002, respectively. Impaired loans with identified reserve requirements were \$47.4 million at January 3, 2004, compared to \$109.9 million at December 28, 2002. The allowance for losses on receivables related to impaired loans with identified reserve requirements was \$17.8 million and \$32.7 million at January 3, 2004 and December 28, 2002, respectively. The average recorded investment in impaired loans during 2003 was \$123.1 million, compared to \$96.7 million in 2002.

Captive finance receivables with recourse that were 90 days or more delinquent amounted to \$69 million, \$85 million and \$90 million at the years ended 2003, 2002 and 2001, respectively, and were 16.1%, 16.1% and 13.9% of captive finance receivables with recourse, respectively. Revenues recognized on these delinquent accounts were approximately \$5.6 million, \$7.4 million and \$9.5 million for the years ended 2003, 2002 and 2001, respectively.

Allowance for Losses on Receivables

	<u>2003</u>	<u>2002</u>	<u>2001</u>
		<i>(In thousands)</i>	
Balance at beginning of year	\$ 144,907	\$ 124,585	\$115,953
Provision for losses	80,941	111,272	68,904
Charge-offs	(131,001)	(113,602)	(69,005)
Recoveries	13,776	10,550	7,496
Acquisitions and other	10,525	12,102	1,237
Balance at end of year	<u>\$ 119,148</u>	<u>\$ 144,907</u>	<u>\$124,585</u>

Managed and Serviced Finance Receivables

Textron Financial manages and services finance receivables for a variety of investors, participants and third-party portfolio owners.

	<u>2003</u>	<u>2002</u>
	<i>(In thousands)</i>	
Total managed and serviced finance receivables	\$ 8,533,659	\$ 8,969,858
Third-party portfolio servicing	(488,133)	(515,546)
Nonrecourse participations	(472,138)	(435,393)
SBA sales agreements	(48,837)	(55,913)
Total managed finance receivables	7,524,551	7,963,006
Securitized receivables	(1,981,398)	(2,428,846)
Other managed finance receivables	(407,906)	—
Owned receivables	<u>\$ 5,135,247</u>	<u>\$ 5,534,160</u>

Nonrecourse participations consist of undivided interests in loans originated by Textron Financial, primarily in vacation interval resorts and golf finance, which are sold to independent investors.

Third-party portfolio servicing largely relates to finance receivable portfolios of resort developers and loan portfolio servicing for third-party financial institutions.

Other managed finance receivables represent the rental streams related to equipment lease portfolios sold to a third-party financial institution, which continue to be serviced and managed by Textron Financial. The Company has a contingent recourse liability related to these portfolios, which minimizes the purchaser's exposure to credit loss and prepayment risk. The maximum liability at January 3, 2004 was \$45 million, and in the event Textron Financial's credit rating falls below BBB, the Company is required to pledge related equipment residuals of \$103 million. The Company recorded a gain upon the sale of the portfolios net of the valuation of the recourse liability based on annual credit loss and prepayment rates of 0.25% and 7.5%, respectively. An instantaneous 20% adverse change in these rates would have a \$0.3 million impact on the valuation of this recourse liability.

Owned receivables include approximately \$37 million of finance receivables that were unfunded at January 3, 2004, primarily as a result of holdback arrangements. The corresponding liability is included in Accrued interest and other liabilities on Textron Financial's Consolidated Balance Sheets.

NOTE 7 Receivable Securitizations

During 2003, the Company securitized general aviation loans, finance receivables for the lease or purchase of E-Z-GO golf cars and Jacobsen turf-care equipment (equipment loans and leases), distribution finance receivables (dealer financing arrangements), and vacation interval loans (timeshare notes receivable). The Company recognized pretax gains as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<i>(In millions)</i>		
General aviation loans	\$ 5.5	\$ 9.5	\$12.3
Equipment loans and leases	2.6	2.9	2.4
Distribution finance receivables	27.6	23.3	16.5
Vacation interval loans	7.1	6.9	1.9
Land loan receivables	—	2.8	6.3
Franchise loans	—	—	3.4
Total pretax gains on securitizations	<u>\$42.8</u>	<u>\$45.4</u>	<u>\$42.8</u>

These gains represent estimates of the cash flows to be received from the Company's retained interests in the loans sold. The retained interests are recorded in Other assets and are in the form of interest-only strips, subordinate seller certificates, cash reserve accounts and rights to receive servicing fees, which range from 50 to 150 basis points. These interests are typically subordinate to the interests of third-party investors and therefore realization of the Company's cash flows is subject to the performance of the receivables sold as compared with the estimates utilized to measure the initial gain. The investors and the securitization trusts have no recourse to the Company's other assets and liabilities for failure of debtors to pay when due. Key economic assumptions used in measuring the retained interests at the date of securitization resulting from securitizations completed during 2003 were as follows:

	<u>General Aviation Aircraft Loans</u>	<u>Equipment Loans and Leases</u>	<u>Distribution Finance Receivables</u>	<u>Vacation Interval Loans</u>
Prepayment speed (annual rate)	23.0%	7.5%	—	10.8%
Weighted average life (in years)	2.0	1.3	0.2	2.1
Expected credit losses (annual rate)	0.5%	1.0%	0.3%	4.7%
Residual cash flows discount rate	4.7%	7.0%	5.7%	6.9%

At January 3, 2004, key economic assumptions and the sensitivity of the current fair value of residual cash flows to immediate 10% and 20% adverse changes in these assumptions are as follows:

	<u>General Aviation Aircraft Loans</u>	<u>Distribution Finance Receivables</u>	<u>Vacation Interval Loans</u>	<u>Land Loan Receivables</u>
	<i>(Dollars in millions)</i>			
Carrying amount of retained interests in securitizations — net	\$100.4	\$121.2	\$16.7	\$16.5
Weighted average life (in years)	<u>1.8</u>	<u>0.2</u>	<u>1.3</u>	<u>2.4</u>
Prepayment speed (annual rate)	<u>21.4%</u>	<u>—</u>	<u>15.0%</u>	<u>20.0%</u>
10% adverse change	\$ (1.9)	—	\$ (0.7)	\$ (0.2)
20% adverse change	<u>(3.6)</u>	<u>—</u>	<u>(1.3)</u>	<u>(0.5)</u>
Expected credit losses (annual rate)	<u>0.5%</u>	<u>0.3%</u>	<u>4.4%</u>	<u>3.0%</u>
10% adverse change	\$ (2.4)	\$ (0.5)	\$ —	\$ (2.3)
20% adverse change	<u>(3.4)</u>	<u>(0.6)</u>	<u>—</u>	<u>(2.8)</u>
Residual cash flows discount rate	<u>4.1%</u>	<u>5.7%</u>	<u>5.1%</u>	<u>5.5%</u>
10% adverse change	\$ (1.2)	\$ (0.3)	\$ (0.2)	\$ (0.4)
20% adverse change	(2.2)	(0.6)	(0.4)	(0.9)

A securitization conduit of equipment loans and leases was voluntarily terminated and liquidated in December 2003.

These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in fair value based on a 10% variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in this table, the effect of a variation in a particular assumption on the fair value of the retained interest is calculated without changing any other assumption, when in reality, changes in one factor may result in another that may magnify or counteract the analysis' losses, such as increases in market interest rates may result in lower prepayments and increased credit losses. Adverse changes in credit loss rates in the vacation interval securitized portfolio typically do not significantly impact the value of Textron Financial's retained interests as the Company does not hold the most subordinate interests in the loans sold. Resort developers, who originate the loan portfolio sold, typically hold both an interest-only strip and a seller certificate, which are subordinate to the interests of Textron Financial and absorb all but severe changes in these credit loss rates.

Static pool losses are calculated by summing the actual and projected future credit losses and dividing them by the original balance of each pool of assets. At January 3, 2004, static pool losses related to term securitizations in the general aviation aircraft loan portfolio are as follows:

	<u>Year Securitized</u>	
	<u>2001</u>	<u>2000</u>
Static pool loss rate.....	1.1%	3.0%

These loss rates relate to 51% of the total securitized general aviation aircraft loans. Static pool losses are not calculated by the Company for revolving period securitizations, which encompass the majority of the securitized portfolio outstanding, as receivables are added to the portfolio on a continual basis and are not tracked as discrete pools. Therefore, loss rates for the entire portfolio are more relevant as a measure of the performance of retained interests related to revolving period securitizations.

Historical loss and delinquency amounts for Textron Financial's securitized portfolio and all similarly managed owned receivables for the year ended January 3, 2004, were as follows:

<u>Type of Finance Receivable</u>	<u>Total Principal Amount of Loans and Leases</u>	<u>Aggregate Contract Value 60 Days or More Past Due</u>	<u>60+ Days Delinquency</u>	<u>Average Balances</u>	<u>Net Credit Losses</u>	<u>Net Credit Losses Annual Rate</u>
	<u>At January 3, 2004</u>			<u>Year-ended January 3, 2004</u>		
<i>(Dollars in millions)</i>						
General aviation aircraft loans	\$1,622.4	\$40.4	2.5%	\$1,674.1	\$24.5	1.5%
Distribution finance receivables	1,698.5	10.2	0.6%	1,675.5	18.5	1.1%
Vacation interval loans	276.7	1.5	0.5%	169.7	1.8	1.1%
Land loan receivables	157.8	10.9	6.9%	171.4	5.4	3.2%
Total loans held and securitized...	<u>\$3,755.4</u>	<u>\$63.0</u>		<u>\$3,690.7</u>	<u>\$50.2</u>	
Consisting of:						
Loans held in portfolio	\$1,510.6	\$30.7				
Loans securitized	<u>2,244.8</u>	<u>32.3</u>				
Total loans held and securitized...	<u>\$3,755.4</u>	<u>\$63.0</u>				

The table below summarizes certain cash flows received from and paid to securitization trusts during the years ended January 3, 2004 and December 28, 2002, respectively.

	<u>2003</u>	<u>2002</u>
<i>(In millions)</i>		
Proceeds from securitizations	\$705.8	\$707.0
Servicing fees received	26.0	20.2
Cash flows received on retained interests	90.1	67.9

NOTE 8 Equipment on Operating Leases

	<u>2003</u>	<u>2002</u>
<i>(In thousands)</i>		
Equipment on operating leases, at cost:		
Aircraft	\$204,826	\$258,337
Golf cars	39,081	34,563
Accumulated depreciation:		
Aircraft and golf cars	(33,725)	(37,845)
Equipment on operating leases — net	<u>\$210,182</u>	<u>\$255,055</u>

Initial lease terms of equipment on operating leases range from one year to ten years. Future minimum rentals at January 3, 2004, are \$25.3 million in 2004, \$20.0 million in 2005, \$13.7 million in 2006, \$10.7 million in 2007, \$7.0 million in 2008 and \$15.3 million thereafter.

NOTE 9 Goodwill

On December 30, 2001, Textron Financial adopted SFAS No. 142, "Goodwill and Other Intangible Assets," which requires companies to stop amortizing goodwill and certain intangible assets with indefinite useful lives and requires an annual review for impairment. All existing goodwill as of December 30, 2001 was required to be tested for impairment on a reporting unit basis with the adoption of this standard. Goodwill is considered to be impaired when the net book value of a reporting unit exceeds its estimated fair value. Fair values were established using a discounted cash flow methodology.

Upon adoption, Textron Financial recorded an after-tax transitional impairment charge of \$15.4 million (\$23.7 million, pre-tax) in the second quarter of 2002, which was retroactively recorded in the first quarter of 2002. This charge is included in the caption "Cumulative effect of change in accounting principle, net of income taxes" in Textron Financial's Consolidated Statements of Income. This after-tax charge related to the Franchise Finance division within the Other segment and was primarily the result of decreasing loan volumes and an unfavorable securitization market.

Textron Financial also adopted the remaining provisions of SFAS No. 141, "Business Combinations," on December 30, 2001. For goodwill and intangible assets reported in connection with acquisitions made prior to July 1, 2001, these provisions broaden the criteria for recording intangible assets separate from goodwill and require that certain intangible assets that do not meet the new criteria, such as workforce, be reclassified into goodwill. Upon adoption of these provisions, intangible assets totaling \$0.9 million were reclassified into goodwill within the Resort Finance segment, for 2002.

Textron Financial sold the portfolio of its small business finance operation on December 19, 2003. The sale resulted in a reduction of goodwill amounting to \$11.6 million. See Note 4 for further details.

Goodwill totaled \$110.0 million in the Resort Finance segment, \$40.6 million in the Asset-Based Lending segment, \$16.6 million in the Aircraft Finance segment and \$2.1 million in the Other segment at January 3, 2004.

The impact on net income of discontinuing the amortization of goodwill is presented below:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
	<i>(In thousands)</i>		
Income before cumulative effect of change in accounting principle	\$80,385	\$75,678	\$120,571
Add back: amortization, net of taxes	<u>—</u>	<u>—</u>	<u>11,217</u>
Adjusted net income before cumulative effect of change in accounting principle	80,385	75,678	131,788
Cumulative effect of change in accounting principle, net of taxes	<u>—</u>	<u>15,372</u>	<u>—</u>
Adjusted net income	<u>\$80,385</u>	<u>\$60,306</u>	<u>\$131,788</u>

NOTE 10 Other Assets

	<u>2003</u>	<u>2002</u>
	<i>(In thousands)</i>	
Retained interests in securitizations	\$197,706	\$210,118
Investment in equipment residuals	109,182	115,394
Interest-only securities	72,505	81,870
Other long-term investments	55,960	24,104
Fixed assets — net	47,205	48,945
Repossessed assets and properties	10,039	36,223
Other	87,375	32,333
Total other assets	<u>\$579,972</u>	<u>\$548,987</u>

The Investment in equipment residuals represents the remaining equipment residual values associated principally with Textron golf and turf equipment lease payments that were securitized in years 2000 through 2003.

The cost of fixed assets is being depreciated using the straight-line method based on the estimated useful lives of the assets.

NOTE 11 Debt and Credit Facilities

	<u>2003</u>	<u>2002</u>
	<i>(In thousands)</i>	
Short-term debt:		
Commercial paper	\$ 496,856	\$ 872,397
Other short-term debt	22,776	43,955
Total short-term debt	519,632	916,352
Long-term debt:		
2.69% — 5.95% notes; due 2004 to 2007	1,638,348	1,152,682
6.00% — 6.84% notes; due 2005 to 2009	563,707	595,836
7.13% note; due 2004	599,432	598,827
7.25% note; due 2007	30,125	25,718
7.37% notes; due 2003	—	213,000
Variable rate notes; due 2004 to 2007	1,055,722	1,337,206
Total long-term debt	3,887,334	3,923,269
Total debt	<u>\$4,406,966</u>	<u>\$4,839,621</u>

During the third quarter, Textron Financial renewed and extended its bank lines of credit. In addition, Textron amended its credit facilities to permit Textron Financial to borrow under those facilities. The Company has committed bank lines of credit of \$1.5 billion, of which \$500 million expires in 2004 and \$1.0 billion expires in 2008. Textron Financial's lines of credit, not reserved as support for commercial paper or utilized for letters of credit at January 3, 2004, were \$966 million. The Company also maintains a CAD 50 million committed facility under which it can borrow an additional CAD 50 million on an uncommitted basis. At January 3, 2004, the Company had used CAD 20 million of the committed portion of the facility. Textron Financial also has a \$25 million multi-currency facility, of which \$17 million remains unused at year-end 2003. Both the Canadian and multi-currency facilities expire in 2004. Textron Financial generally pays fees in support of these lines.

Textron Financial had interest rate exchange agreements related to the conversion of fixed rate debt to variable rate debt at the time of issuance, of \$1.9 billion and \$1.4 billion at January 3, 2004, and December 28,

2002, respectively, whereby the Company makes periodic floating rate payments in exchange for periodic fixed rate receipts.

Through its subsidiary, Textron Financial Canada Funding Corp. (Textron Canada Funding), the Company periodically issues debt securities. Textron Financial owns 100% of the common stock of Textron Canada Funding. Textron Canada Funding is a financing subsidiary of Textron Financial with no operations, revenues or cash flows other than those related to the issuance, administration and repayment of debt securities that are fully and unconditionally guaranteed by Textron Financial.

The weighted average interest rates on short-term borrowings at year-end were as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Commercial paper	1.23%	1.68%	2.37%
Other short-term debt	3.55%	2.98%	2.41%

The corresponding weighted average interest rates on these borrowings during the last three years were 1.47% in 2003, 2.07% in 2002 and 4.12% in 2001. Weighted average interest rates have been determined by relating interest costs for each year to the daily average dollar amounts outstanding.

Interest on Textron Financial’s variable rate notes is predominately tied to the three-month LIBOR for U.S. Dollar deposits. The weighted average interest rate on these notes before consideration of the effect of interest rate exchange agreements, was 2.29% at January 3, 2004, 2.16% at December 28, 2002, and 2.41% at December 29, 2001. The corresponding weighted average interest rates on these notes during the last three years were 2.47% in 2003, 2.58% in 2002 and 4.89% in 2001.

Securitizations are an important source of liquidity for Textron Financial and involve the periodic transfer of finance receivables to qualified special purpose trusts. At January 3, 2004, and December 28, 2002, the amount of debt related to these securitization trusts was \$1.9 billion and \$2.3 billion, respectively.

The amount of net assets available for dividends and other payments to Textron is restricted by the terms of the Company’s lending agreements. At January 3, 2004, \$480 million of net assets were available to be transferred to Textron under the most restrictive covenant. The lending agreements contain various restrictive provisions regarding additional debt (not to exceed 800% of consolidated net worth and qualifying subordinated obligations), minimum net worth (\$200 million), the creation of liens and the maintenance of a fixed charges coverage ratio (no less than 125%).

Required principal payments on long-term debt outstanding at January 3, 2004, are \$1,181 million in 2004, \$581 million in 2005, \$809 million in 2006, \$819 million in 2007 and \$497 million in 2009.

Cash payments made by Textron Financial for interest were \$182 million in 2003, \$196 million in 2002 and \$282 million in 2001.

NOTE 12 Derivative Financial Instruments

Textron Financial utilizes derivative instruments to mitigate its exposure to fluctuations in interest rates and foreign currencies. These instruments include interest rate exchange agreements, foreign currency exchange agreements and interest rate cap and floor agreements. The Company does not hold or issue derivative financial instruments for trading or speculative purposes and did not experience a significant net gain or loss in earnings as a result of the ineffectiveness, or the exclusion of any component from its assessment of hedge effectiveness, of its derivative financial instruments in 2003, 2002 and 2001.

In order to mitigate exposure to changes in the fair value of its fixed rate portfolios of receivables and debt due to changes in interest rates, the Company enters into interest rate exchange agreements, which convert its fixed rate cash flows to floating rates. The Company has designated these instruments as fair value hedges. Changes in the fair value of these instruments are recorded in Finance charges and discounts and Interest expense related to hedges of receivables and debt, respectively, and the corresponding offsetting changes in value in the hedged receivables and debt are also recorded in Finance charges and discounts and Interest

expense. At January 3, 2004, the Company had interest rate exchange agreements with a fair value of \$8.1 million designated as fair value hedges, compared to a fair value of \$42.2 million at December 28, 2002.

Textron Financial has also entered into interest rate exchange, cap and floor agreements to mitigate its exposure to variability in the cash flows received from its investments in interest-only securities resulting from securitizations, which are caused by fluctuations in interest rates. The combination of these instruments convert net residual floating rate cash flows expected to be received by the Company as a result of the securitization trust's assets, liabilities and derivative instruments to fixed rate cash flows and are designated as cash flow hedges. Changes in the fair value of these instruments are recorded net of the tax effect in Other comprehensive income. At January 3, 2004, these instruments had a fair value liability of \$13.7 million, compared to a fair value liability of \$37.4 million at December 28, 2002. The Company expects approximately \$2.0 million of net of tax deferred losses to be reclassified to earnings related to these hedge relationships in 2004.

At January 3, 2004, the Company had \$8.2 million of net of tax deferred losses recorded in Other comprehensive income related to terminated forward starting interest rate exchange agreements. These agreements were executed to hedge the exposure to the variability in cash flows from anticipated future issuances of fixed rate debt and were terminated upon issuance of the debt. The Company is amortizing the deferred losses into Interest expense over the remaining life of the hedged debt of 50 months and expects approximately \$1.9 million, net of income taxes, deferred losses to be reclassified to earnings in 2004.

Textron Financial utilizes foreign currency interest rate exchange agreements to hedge the exposure through March 2005, in a Canadian dollar functional currency subsidiary, to fluctuations in the cash flows to be received on \$107.0 million of LIBOR based variable rate notes receivable as a result of changes in both foreign currency exchange rates and LIBOR. The Company has designated these agreements cash flow hedges and records changes in the fair value of these instruments net of tax in Other comprehensive income. At January 3, 2004, these instruments had a fair value of \$26.0 million, compared to a fair value of \$3.4 million at December 28, 2002. The Company expects approximately \$3.0 million of net of tax deferred gains to be reclassified to earnings related to these hedge relationships in 2004.

The Company also utilizes foreign currency interest rate exchange agreements to hedge its exposure, in a Canadian dollar functional currency subsidiary, to changes in the fair value of \$60.0 million U.S. dollar denominated fixed rate debt as a result of changes in both foreign currency exchange rates and Canadian Banker's Acceptance rates. The Company has designated these agreements as fair value hedges and records changes in the fair value of these instruments, as well as the corresponding changes in the fair value of the debt being hedged in Interest expense. At January 3, 2004, these instruments had a fair value liability of \$1.1 million. At December 28, 2002, the Company had similar instruments hedging \$32.5 million U.S. dollar denominated fixed rate debt, which had a fair value asset of \$0.8 million.

In relation to one of the Company's asset-backed securitizations, Textron Financial enters into back-to-back interest rate exchange agreements with both third-party financial institutions and commercial customers of the Resort Finance Segment. These instruments are designed to have an equal and offsetting impact to the Company and transfer the risk of differences between actual and scheduled cash flows related to the receivables sold from the financial institution to the commercial customers who originated the loan contracts sold. Since these instruments are utilized by Textron Financial to facilitate the securitization transaction rather than mitigate interest rate risk to the Company, they are not designated in hedging relationships. There were no gains and losses related to these instruments in the Company's earnings in 2003.

NOTE 13 Textron Financial and Litchfield Obligated Mandatory Redeemable Preferred Securities of Trust Subsidiary Holding Solely Litchfield Junior Subordinated Debentures

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity," that became effective at the beginning of the third quarter of 2003. SFAS No. 150 established standards for how an issuer classifies and measures certain financial instruments with characteristics of liabilities and equity. Financial instruments within its scope that were previously classified as equity, such as mandatorily redeemable shares, must be classified as a liability. Upon

adoption, Textron Financial classified its obligated mandatory redeemable preferred securities as a liability and related distributions on preferred securities as interest expense. Subsequent to this adoption, in November 2003, the FASB issued staff position (FSP) 150-3 which indefinitely deferred SFAS No. 150 for these obligated mandatorily redeemable preferred securities. Refer to Note 1 to the consolidated financial statements for additional information.

Prior to Textron Financial's acquisition of Litchfield on November 3, 1999, a trust, sponsored and wholly-owned by Litchfield, issued to the public \$26.2 million of mandatory redeemable preferred securities (Preferred Securities). The trust subsequently invested the proceeds in \$26.2 million aggregate principal amount of Litchfield 10% Series A Junior Subordinated Debentures (Series A Debentures), due 2029. The Series A Debentures are the sole asset of the trust. The amounts due to the trust under the Series A Debentures and the related income statement amounts have been eliminated in Textron Financial's consolidated financial statements.

The Preferred Securities were recorded by Textron Financial at the fair value of \$28.6 million as of the acquisition date and the fair value adjustment is being amortized through June 2004.

The Preferred Securities accrue and pay cash distributions quarterly at a rate of 10% per annum. The trust's obligations under the Preferred Securities are fully and unconditionally guaranteed by Litchfield, including, without limitation, all obligations arising under the Declaration Trust, the Trust Preferred Securities, the Indenture, the Debentures and the ancillary agreements entered into in connection with the foregoing. The trust will redeem all of the outstanding Preferred Securities when the Series A Debentures are paid at maturity on June 30, 2029, or otherwise become due. Litchfield will have the right to redeem 100% of the principal plus accrued and unpaid interest on or after June 30, 2004.

As a result of the acquisition, Textron Financial has agreed to make payments to the holders of the Preferred Securities, when due, to the extent not paid by or on behalf of the trust or the subsidiary.

NOTE 14 Investment in Parent Company Preferred Stock

On April 12, 2000, Textron made a \$25 million noncash capital contribution to Textron Financial consisting of all of the outstanding shares of Textron Funding Corporation (Textron Funding), a related corporate holding company. Textron Funding's only asset is 1,522 shares of Textron Inc. Series D cumulative preferred stock, bearing an annual dividend yield of 5.92%. The preferred stock, which has a face value of \$152.2 million, is carried at its original cost of \$25 million and is presented in a manner similar to treasury stock for financial reporting purposes. Dividends on the preferred stock are treated as additional capital contributions from Textron.

NOTE 15 Accumulated Other Comprehensive Loss

	<u>January 3, 2004</u>	<u>December 28, 2002</u>
	<i>(In thousands)</i>	
Beginning of year	\$(14,637)	\$(18,793)
Net deferred gain (loss) on hedge contracts, net of income taxes of \$6,871 and income tax benefit of \$2,519	11,452	(4,198)
Amortization of deferred loss on terminated hedge contracts, net of income taxes of \$1,858 and \$1,383, respectively	3,450	2,305
Foreign currency translation adjustments	1,511	(3,552)
Net deferred (loss) gain on interest-only securities, net of income tax benefit of \$1,859 and \$5,761, respectively	<u>(3,452)</u>	<u>9,601</u>
End of year	<u>\$ (1,676)</u>	<u>\$(14,637)</u>

NOTE 16 Income Taxes

Income from continuing operations before income taxes and distributions on preferred securities:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
		<i>(In thousands)</i>	
United States	\$109,350	\$122,475	\$189,917
Foreign	7,164	(2,095)	889
Total	<u>\$116,514</u>	<u>\$120,380</u>	<u>\$190,806</u>

The components of income taxes were as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
		<i>(In thousands)</i>	
Current:			
Federal	\$ 54,001	\$(25,723)	\$26,143
State	10,758	10,005	2,321
Foreign	452	636	702
Total current income taxes	65,211	(15,082)	29,166
Deferred:			
Federal	(22,656)	64,957	37,423
State	(7,549)	(5,848)	3,241
Foreign	1,920	(1,576)	—
Total deferred income taxes	(28,285)	57,533	40,664
Total income taxes	<u>\$ 36,926</u>	<u>\$ 42,451</u>	<u>\$69,830</u>

Cash (received) paid for income taxes was (\$5.5) million in 2003, (\$30.8) million in 2002 and \$15.8 million in 2001.

The federal statutory income tax rate was reconciled to the effective income tax rate as follows:

	<u>2003</u>	<u>2002</u>	<u>2001</u>
Federal statutory income tax rate	35.0%	35.0%	35.0%
State income taxes	1.9	2.3	1.6
Tax exempt interest	(0.3)	(0.5)	(0.3)
Favorable tax settlement	(1.8)	—	—
Foreign tax rate differential	(2.1)	(1.6)	(0.5)
Goodwill	—	—	1.7
Other, net	(1.0)	0.1	(0.9)
Effective income tax rate	<u>31.7%</u>	<u>35.3%</u>	<u>36.6%</u>

The components of Textron Financial's deferred tax assets and liabilities were as follows:

	<u>2003</u>	<u>2002</u>
	<i>(In thousands)</i>	
Deferred tax assets:		
Allowance for losses	\$ 23,945	\$ 40,344
State net operating losses	14,939	12,448
Deferred origination fees	4,396	5,154
Nonaccrual loans	5,461	5,455
Other	<u>27,159</u>	<u>43,856</u>
Total deferred tax assets	75,900	107,257
Valuation allowance	<u>(5,785)</u>	<u>(5,071)</u>
Net deferred tax assets	70,115	102,186
Deferred tax liabilities:		
Leveraged leases	353,016	318,880
Finance leases	10,667	114,645
Equipment on operating leases	48,372	32,871
Other	<u>47,713</u>	<u>33,989</u>
Total deferred tax liabilities	<u>459,768</u>	<u>500,385</u>
Net deferred tax liabilities	<u>\$389,653</u>	<u>\$398,199</u>

At January 3, 2004, Textron Financial had state net operating loss carryforwards of approximately \$379 million available to offset future state taxable income. The state net operating loss carryforwards will expire in years 2004 through 2022. The valuation allowance reported above represents the tax effect of certain state net operating loss carryforwards. Textron Financial is unable to conclude that "more likely than not" it will realize the benefit from such carryforwards.

NOTE 17 Fair Value of Financial Instruments

The following methods and assumptions were used in estimating the fair value of Textron Financial's financial instruments:

Finance Receivables

The estimated fair values of fixed rate installment contracts, revolving loans, golf course and resort mortgages and distribution finance receivables were estimated based on discounted cash flow analyses using interest rates currently being offered for similar loans to borrowers of similar credit quality. The estimated fair values of all variable rate receivables approximated the net carrying value of such receivables. The estimated fair values of nonperforming loans were based on independent appraisals, discounted cash flow analyses using risk adjusted interest rates or Textron Financial valuations based on the fair value of the related collateral. The fair values, net of carrying amounts of Textron Financial's leveraged leases, finance leases and operating leases (\$513.2 million, \$308.9 million and \$210.2 million, respectively, at January 3, 2004, and \$460.2 million, \$345.0 million and \$255.1 million, respectively, at December 28, 2002), are specifically excluded from this disclosure under generally accepted accounting principles. As a result, a significant portion of the assets which are included in the Company's asset and liability management strategy are excluded from this fair value disclosure.

Debt, Interest Rate Exchange Agreements, Foreign Currency Forward Exchange Contracts and Foreign Currency Exchange Agreements

The estimated fair value of fixed rate debt and variable rate long-term notes was determined by either independent investment bankers or discounted cash flow analyses using interest rates for similar debt with

maturities similar to the remaining terms of the existing debt. The fair values of short-term borrowing supported by credit facilities approximated their carrying values. The estimated fair values of interest rate exchange agreements, foreign currency forward exchange contracts and foreign currency exchange agreements, were determined by independent investment bankers and represent the estimated amounts that Textron Financial would be required to pay to (or collect from) a third party to assume Textron Financial's obligations under the agreements.

The carrying values and estimated fair values of Textron Financial's financial instruments for which it is practicable to calculate a fair value are as follows:

	<u>2003 Carrying Value</u>	<u>2003 Estimated Fair Value</u>	<u>2002 Carrying Value</u>	<u>2002 Estimated Fair Value</u>
	<i>(In thousands)</i>			
Assets:				
Installment contracts	\$1,411,796	\$1,388,045	\$1,795,756	\$1,789,165
Interest rate exchange agreements on installment contracts	(15,330)	(15,330)	(21,274)	(21,274)
Revolving loans	1,194,113	1,180,859	1,199,711	1,184,293
Golf course and resort mortgages	944,522	946,559	962,459	968,580
Distribution finance receivables	777,979	773,928	792,323	786,835
Retained interests in securitizations	270,211	270,211	291,988	291,988
Allowance for losses on receivables	(117,151)	—	(139,464)	—
	<u>\$4,466,140</u>	<u>\$4,544,272</u>	<u>\$4,881,499</u>	<u>\$4,999,587</u>
Liabilities:				
Total short-term debt	\$ 519,632	\$ 519,632	\$ 916,352	\$ 916,352
Variable rate long-term notes	1,055,722	1,074,329	1,337,206	1,309,401
Variable rate long-term notes related derivatives	(22,258)	(22,258)	(67,039)	(67,039)
Fixed rate long-term debt	2,853,870	2,980,399	2,586,063	2,709,483
Amounts due to Textron Inc.	21,525	19,546	23,471	21,157
Retained interests in securitizations	18,160	18,160	23,108	23,108
Foreign currency forward exchange contracts . . .	—	—	(24)	(24)
	<u>\$4,446,651</u>	<u>\$4,589,808</u>	<u>\$4,819,137</u>	<u>\$4,912,438</u>

NOTE 18 Commitments

Textron Financial generally enters into various revolving lines of credit, letters of credit and loan commitments in response to the financing needs of its customers. The revolving lines of credit include both committed and uncommitted facilities. Included in the committed facilities are \$283 million of commitments where funding is dependent on compliance with customary financial covenants. Advances under the remaining \$840 million of committed facilities are dependent on both compliance with customary financial covenants and the availability of eligible collateral. Advances under the uncommitted facilities of \$243 million are generally at Textron Financial's discretion and the Company has the right to reduce or cancel these lines at any time. Letters of credit are conditional commitments issued by the Company to guarantee the performance of a borrower or an affiliate to a third party. Loan commitments represent agreements to fund eligible costs of assets generally within one year. Generally, interest rates on all of these commitments are not set until amounts are funded. Therefore, Textron Financial is not exposed to interest rate changes.

These financial instruments generate fees and involve, to varying degrees, elements of credit risk in excess of amounts recognized in the Company's consolidated balance sheets. Since many of the agreements are expected to expire unused, the total commitment amount does not necessarily represent future cash requirements. The credit risk involved in issuing these instruments is essentially the same as that involved in

extending loans to borrowers and the credit quality and collateral policies for controlling this risk are similar to those involved in the Company's normal lending transactions.

The contractual amounts of the Company's outstanding commitments to extend credit at January 3, 2004, are shown below:

	<i>(In millions)</i>
Commitments to extend credit:	
Committed revolving lines of credit	\$1,123
Uncommitted revolving lines of credit	243
Standby letters of credit	47
Loans	18

Textron Financial's offices are occupied under noncancelable operating leases expiring on various dates through 2009. Rental expense was \$7.4 million in 2003 (\$7.6 million in 2002 and \$6.4 million in 2001). Future minimum rental commitments for all noncancelable operating leases in effect at January 3, 2004, approximated \$4.8 million for 2004, \$3.3 million for 2005, \$2.5 million for 2006, \$2.3 million for 2007 and \$2.3 million for 2008. Of these amounts, \$0.7 million in 2004 and \$0.1 million in 2005 are payable to Textron and its subsidiaries.

NOTE 19 Contingencies

In March 2003, the United States Department of Justice (DOJ) authorized the filing of a civil action against Textron Financial and its Litchfield Financial Corporation (Litchfield), and other third parties, arising from the financing of certain land purchases by consumers through a third-party land developer commonly known as "Buyer's Source." During the third quarter, the Company entered into a settlement agreement with DOJ, which required the Company to offer affected consumers various options, ranging from cash payments to forgiveness of debt in exchange for return of the property. The Florida Attorney General's office also opened a preliminary investigation into Litchfield's activities relative to Buyer's Source and, while the Company believes it has good defenses to any potential claims by the State of Florida, it is engaged in settlement discussions with Florida. On February 3, 2004, in the Court of Common Pleas for Knox County, Ohio, a purported class action lawsuit was commenced against the Company and Litchfield, certain of their current and former officers, and other third-parties, related to the Buyer's Source matter. Among other claims, the purported class action alleges fraud in the financing of the third-party land developers described above and seeks compensatory damages and punitive damages in excess of \$10 million. The Company intends to aggressively defend this litigation. The Company believes that the purported class action will not have a material effect on the Company's financial position and results of operations.

There are other pending or threatened lawsuits and other proceedings against Textron Financial and its subsidiaries. Some of these suits and proceedings seek compensatory, treble or punitive damages in substantial amounts. These suits and proceedings are being defended by, or contested on behalf of, Textron Financial and its subsidiaries. On the basis of information presently available, Textron Financial believes any such liability would not have a material effect on Textron Financial's financial position or results of operations.

NOTE 20 Subsequent Events

On January 22, 2004, Litchfield, and its former CFO, entered into a memorandum of understanding, subject to court approval, relating to a pending class action (DynaCorp litigation) arising from the sale of promissory notes issued by, and the operation of, certain trusts organized by DynaCorp Financial Strategies Inc. ("DFS"). This class action litigation, which was filed in 2001 in Superior Court in Marin County, California, alleged that DFS and the trusts engaged in a variety of improper dealings with regard to the sale by the trusts of notes and the operation of the trusts. During a portion of the time that the allegedly improper activities occurred, Litchfield extended credit to DFS and was a shareholder of DFS, and a Litchfield officer was a director on DFS' Board. The preliminary settlement under the memorandum of understanding was

accrued as part of legal costs and was reflected in Selling and administrative expenses on the Consolidated Statements of Income for the year-ended January 3, 2004.

NOTE 21 Financial Information About Industry Segments

The Company aligns its business units into six operating segments based on the markets serviced and the products offered: Aircraft Finance, Asset-Based Lending, Distribution Finance, Golf Finance, Resort Finance and Structured Capital. In addition, the Company maintains an Other segment (non-core) that includes franchise finance, media finance in addition to liquidating portfolios related to a strategic realignment of the Company's business and product lines into core and non-core businesses.

	<u>2003</u>		<u>2002</u>		<u>2001</u>	
			<i>(In thousands)</i>			
Revenues						
Distribution Finance	\$ 151,199	26%	\$ 103,470	18%	\$ 89,807	13%
Resort Finance	87,290	15%	95,760	16%	106,072	16%
Golf Finance	81,311	15%	72,387	12%	67,751	10%
Aircraft Finance	80,324	14%	93,469	16%	124,643	18%
Asset-Based Lending	58,694	10%	62,408	11%	75,798	11%
Structured Capital	35,085	6%	38,195	7%	42,519	6%
Other	<u>77,979</u>	<u>14%</u>	<u>118,441</u>	<u>20%</u>	<u>174,337</u>	<u>26%</u>
Total revenues	<u>\$ 571,882</u>	<u>100%</u>	<u>\$ 584,130</u>	<u>100%</u>	<u>\$ 680,927</u>	<u>100%</u>
Income (loss) before special charges, income taxes, distributions on preferred securities and cumulative effect of change in accounting principle (1) (2)						
Distribution Finance	\$ 57,706		\$ 39,734		\$ 32,849	
Resort Finance	25,780		42,783		41,378	
Golf Finance	27,731		22,161		21,214	
Aircraft Finance	9,945		7,772		34,821	
Asset-Based Lending	19,811		13,811		24,019	
Structured Capital	11,979		19,869		29,029	
Other	<u>(30,129)</u>		<u>(25,750)</u>		<u>10,182</u>	
Income from continuing operations before special charges, income taxes and distributions on preferred securities	122,823		120,380		193,492	
Special charges	<u>(6,309)</u>		<u>—</u>		<u>(2,686)</u>	
Income from continuing operations before income taxes and distributions on preferred securities	<u>\$ 116,514</u>		<u>\$ 120,380</u>		<u>\$ 190,806</u>	

	<u>2003</u>	<u>2002</u>	<u>2001</u>
		<i>(In thousands)</i>	
Finance assets (3)			
Aircraft Finance	\$1,160,029	\$1,216,144	\$1,248,305
Resort Finance	1,070,352	1,052,734	1,021,034
Golf Finance	886,011	964,271	836,421
Distribution Finance	824,618	841,118	495,809
Structured Capital	634,308	581,207	565,047
Asset-Based Lending	467,759	521,067	548,093
Other	747,744	<u>1,080,383</u>	<u>1,209,862</u>
Total finance assets	<u>\$5,790,821</u>	<u>\$6,256,924</u>	<u>\$5,924,571</u>

- (1) Interest expense is allocated to each segment in proportion to its net investment in finance assets. Net investment in finance assets includes deferred income taxes, security deposits and other specifically identified liabilities. The interest allocated matches, to the extent possible, variable rate debt with variable rate finance assets and fixed rate debt with fixed rate finance assets.
- (2) Indirect expenses are allocated to each segment based on the use of such resources. Most allocations are based on the segment's proportion of net investment in finance assets, headcount, number of transactions, computer resources and senior management time.

- (3) Finance assets include: finance receivables; equipment on operating leases, net of accumulated depreciation; repossessed assets and properties; retained interests in securitizations; interest-only securities; investment in equipment residuals; ADC arrangements; and short and long-term investments (some of which are classified in Other assets on Textron Financial's Consolidated Balance Sheets).

NOTE 22 Quarterly Financial Data (Unaudited)

	First Quarter		Second Quarter		Third Quarter		Fourth Quarter	
	2003	2002	2003	2002	2003	2002	2003	2002
	<i>(In thousands)</i>							
Revenues	\$140,046	\$130,373	\$142,532	\$137,040	\$135,707	\$145,922	\$153,597	\$170,795
Net interest margin	91,806	82,806	93,702	86,317	87,777	94,848	109,415	120,446
Selling and administrative	44,365	37,961	43,580	39,164	45,671	35,827	45,320	39,813
Provision for losses	24,002	24,584	26,034	18,481	18,047	38,217	12,858	29,990
Special charges	—	—	—	—	—	—	6,309	—
Cumulative effect of change in accounting principle, net of tax benefit	—	15,372	—	—	—	—	—	—
Net income	15,547	(1,196)	17,049	18,536	15,930	12,278	31,859	30,688

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We have carried out an evaluation, under the supervision and with the participation of our management, including our Chairman and Chief Executive Officer (the "CEO") and our Executive Vice President and Chief Financial Officer (the "CFO"), of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Act")) as of the end of the year covered by this report. Based upon that evaluation, our CEO and CFO concluded that our disclosure controls and procedures are effective in providing reasonable assurance that (a) the information required to be disclosed by us in the reports that we file or submit under the Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and (b) such information is accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

There has been no change in our internal control over financial reporting during the fourth quarter of the fiscal year covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART III.

Item 10. Directors and Executive Officers of the Registrant

Omitted per Instruction I of Form 10-K.

Item 11. Executive Compensation

Omitted per Instruction I of Form 10-K.

Item 12. Security Ownership of Certain Beneficial Owners and Management

Omitted per Instruction I of Form 10-K.

Item 13. *Certain Relationships and Related Transactions*

Omitted per Instruction I of Form 10-K.

Item 14. *Principal Accountant Fees and Services*

The aggregate fees for professional services rendered by Ernst & Young LLP during 2003 and 2002 were as follows:

Audit Fees — Fees for the audit of Textron Financial's annual financial statements, the reviews of the financial statements in Textron Financial's Forms 10-Q, and other services in connection with statutory and regulatory filings and engagements were \$1.0 million and \$0.9 million, in 2003 and 2002, respectively.

Audit Related Fees — Audit related services include agreed upon procedures relating to securitizations of finance receivables, attest services not required by statute or regulation, and consultations concerning financial accounting and reporting matters not classified as audit. Fees were \$0.3 million and \$0.3 million in 2003 and 2002, respectively.

Tax Services — Fees for tax services relating to consultations and compliance were \$21 thousand and \$36 thousand in 2003 and 2002, respectively.

Other Services — Other service fees relating to miscellaneous services were \$0.1 million and \$0.1 million in 2003 and 2002, respectively.

No fees were paid to Ernst & Young LLP for financial information systems design and implementation services during 2003 or 2002.

PART IV.

Item 15. *Exhibits, Financial Statement Schedules and Reports on Form 8-K*

(a) List of Financial Statements and Financial Statement Schedules

The following consolidated financial statements of Textron Financial and subsidiaries are included in Item 8:

1. Consolidated statements of income — Years ended January 3, 2004, December 28, 2002 and December 29, 2001
2. Consolidated balance sheets — January 3, 2004 and December 28, 2002
3. Consolidated statements of cash flows — Years ended January 3, 2004, December 28, 2002 and December 29, 2001
4. Consolidated statements of changes in shareholder's equity — Years ended January 3, 2004, December 28, 2002 and December 29, 2001
5. Notes to consolidated financial statements

All other schedules for which provision is made in the applicable accounting regulation of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and therefore have been omitted.

Exhibits

The following is an Index of Exhibits required by Item 601 of Regulation S-K filed with the Securities and Exchange Commission as part of this report.

<u>Exhibit No.</u>	
3.1*	Restated Certificate of Incorporation of Textron Financial, dated July 19, 1993
3.2**	By-Laws of Textron Financial as of May 2, 2000
4.1***	Indenture dated as of December 9, 1999, between Textron Financial Corporation and SunTrust Bank (formerly known as Sun Trust Bank, Atlanta), (including form of debt securities)
4.2****	Indenture dated as of November 30, 2001, between Textron Financial Canada Funding Corp. and SunTrust Bank, guaranteed by Textron Financial Corporation
10.1*	Support Agreement dated as of May 25, 1994, between Textron Financial and Textron
10.2*	Receivables Purchase Agreement between Textron Financial and Textron dated as of January 1, 1986
10.3*	Tax Sharing Agreement between Textron Financial and Textron dated as of December 29, 1990
10.4	364-Day Credit Agreement dated July 28, 2003 among Textron Financial Corporation, the Banks listed therein, and JPMorgan Chase Bank, as Administrative Agent. Incorporated by reference to Exhibit 10.1 to Textron Financial Corporation's Report on 8-K as filed on August 26, 2003.
10.5	Five-Year Credit Agreement dated July 28, 2003 among Textron Financial Corporation, the Banks listed therein, and JPMorgan Chase Bank, as Administrative Agent. Incorporated by reference to Exhibit 10.2 to Textron Financial Corporation's Report on 8-K as filed on August 26, 2003.
10.6	364-Day Credit Agreement dated March 31, 2003 among Textron Inc., the Banks listed therein, and JPMorgan Chase Bank, as Administrative Agent. Incorporated by reference to Exhibit 10.3 to Textron Inc.'s Quarterly Report on Form 10-Q for the fiscal quarter ended March 29, 2003.
10.7	Five-Year Credit Agreement dated April 1, 2002 among Textron Inc., the Banks listed therein, and JPMorgan Chase Bank, as Administrative Agent. Incorporated by reference to Exhibit 10.2 to Textron Inc.'s Quarterly Report on Form 10-Q for the fiscal quarter ended March 29, 2003.
10.8	Amendment to Five-Year and 364-Day Credit Agreements among Textron Inc., the Banks listed therein, and JPMorgan Chase Bank, as Administrative Agent. Incorporated by reference to Exhibit 10.5 to Textron Financial Corporation's Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2003.
12	Computation of Ratios of Earnings to Fixed Charges
21	List of significant subsidiaries
23	Consent of Independent Auditors
24	Power of Attorney dated as of February 18, 2004
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)
32.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350
32.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350

Note: Instruments defining the rights of holders of certain issues of long-term debt of Textron Financial have not been filed as exhibits to this Report because the authorized principal amount of any one of such issues does not exceed 10% of the total assets of Textron Financial and its subsidiaries on a consolidated basis. Textron Financial agrees to furnish a copy of each such instrument to the Commission upon request.

* Incorporated by reference to the Exhibit with the same number of Textron Financial's Registration Statement on Form 10 (File No. 0-27559)

- ** Incorporated by reference to Exhibit 3.1 of Textron Financial's quarterly report on Form 10-Q dated August 11, 2000
- *** Incorporated by reference to Exhibit 4.1 to Amendment No. 2 to Textron Financial Corporation's Registration Statement on Form S-3 (No. 333-88509)
- **** Incorporated by reference to Exhibit 4.2 to Amendment No. 1 to Textron Financial Corporation's Registration Statement on Form S-3 (No. 333-108464)

(b) Reports on Form 8-K

No reports on Form 8-K were filed during the quarter ended January 3, 2004.

Textron Financial, Textron, Bell Helicopter, Cessna, Cessna Finance Corporation, Asset Control, LLC, Textron Business Services, Inc., Textron Golf, Turf and Specialty Products, E-Z-GO, Jacobsen turf-care and their related trademark designs and logotypes (and variations of the foregoing) are trademarks, trade names or service marks of Textron Inc., its subsidiaries, affiliates or joint ventures.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized on this 26th day of February 2004.

Textron Financial Corporation
Registrant

By: _____ *

Ted R. French
Chairman and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below on this 26th day of February 2004, by the following persons on behalf of the registrant and in the capacities indicated:

By: _____ *

Ted R. French
Chairman and Chief Executive Officer,
Director (Principal Executive Officer)

By: _____ *

Buell J. Carter, Jr.
President and Chief Operating Officer,
Director

By: _____ *

Mary F. Lovejoy
Director

By: /s/ THOMAS J. CULLEN _____
Thomas J. Cullen
Executive Vice President and Chief Financial
Officer (Principal Financial Officer)

By: /s/ ERIC SALANDER _____
Eric Salander
Senior Vice President, Finance
(Principal Accounting Officer)

*By: /s/ ELIZABETH C. PERKINS _____
Elizabeth C. Perkins
Attorney-in-fact