
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 10-Q

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

For the fiscal quarter ended June 30, 2003

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
(State or Other Jurisdiction of
Incorporation or Organization)

05-6008768
(I.R.S. Employer
Identification No.)

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

(Address and telephone number of Principal Executive Offices)

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

All of the shares of common stock of the registrant are owned by Textron Inc.

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PART I. FINANCIAL INFORMATION

Item 1. *Financial Statements*

TEXTRON FINANCIAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	<u>2003</u>	<u>2002</u>	<u>2003</u>	<u>2002</u>
	(In thousands)			
Revenues				
Finance charges and discounts	\$116,851	\$105,488	\$228,167	\$210,633
Rental revenues on operating leases	6,306	7,141	14,019	14,205
Other income	<u>31,976</u>	<u>36,393</u>	<u>63,675</u>	<u>68,260</u>
	155,133	149,022	305,861	293,098
Expenses				
Interest	47,205	48,858	92,499	95,156
Selling and administrative	46,472	42,549	93,756	83,525
Provision for losses	31,184	25,011	60,921	55,386
Depreciation of equipment on operating leases	<u>3,757</u>	<u>3,419</u>	<u>8,295</u>	<u>6,964</u>
	<u>128,618</u>	<u>119,837</u>	<u>255,471</u>	<u>241,031</u>
Income before income taxes, distributions on preferred securities and cumulative effect of change in accounting principle				
	26,515	29,185	50,390	52,067
Income taxes	9,082	10,281	17,046	18,630
Distributions on preferred securities (net of tax benefits of \$184, \$190, \$368 and \$391, respectively)	<u>384</u>	<u>368</u>	<u>748</u>	<u>725</u>
Income before cumulative effect of change in accounting principle	17,049	18,536	32,596	32,712
Cumulative effect of change in accounting principle (net of tax benefit of \$8,278)	<u>—</u>	<u>—</u>	<u>—</u>	<u>15,372</u>
Net income	<u><u>\$ 17,049</u></u>	<u><u>\$ 18,536</u></u>	<u><u>\$ 32,596</u></u>	<u><u>\$ 17,340</u></u>

See notes to condensed consolidated financial statements (unaudited).

Item 1. Financial Statements (Continued)

TEXTRON FINANCIAL CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	<u>June 30,</u> <u>2003</u>	<u>December 28,</u> <u>2002</u>
	(Dollars in thousands)	
Assets		
Cash and equivalents	\$ 45,635	\$ 21,287
Finance receivables, net of unearned income:		
Installment contracts	1,745,573	1,827,797
Revolving loans	1,700,865	1,366,064
Golf course and resort mortgages	951,552	962,459
Distribution finance receivables	843,757	792,323
Leveraged leases	463,234	460,163
Finance leases	<u>314,102</u>	<u>346,844</u>
Total finance receivables	6,019,083	5,755,650
Allowance for losses on receivables	<u>(165,072)</u>	<u>(166,510)</u>
Finance receivables — net	5,854,011	5,589,140
Equipment on operating leases — net	221,862	255,055
Goodwill	180,843	180,843
Other assets	<u>698,204</u>	<u>608,003</u>
Total assets	<u><u>\$7,000,555</u></u>	<u><u>\$6,654,328</u></u>
Liabilities and shareholder's equity		
Liabilities		
Accrued interest and other liabilities	\$ 478,731	\$ 345,270
Amounts due to Textron Inc.	22,793	23,471
Deferred income taxes	434,298	398,199
Debt	<u>4,994,446</u>	<u>4,839,621</u>
Total liabilities	5,930,268	5,606,561
Textron Financial and Litchfield obligated mandatory redeemable preferred securities of trust subsidiary holding solely Litchfield junior subordinated debentures	26,685	26,950
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 income (loss)	10,552	(14,637)
Retained earnings	<u>484,124</u>	<u>486,528</u>
Total shareholder's equity	<u>1,043,602</u>	<u>1,020,817</u>
Total liabilities and shareholder's equity	<u><u>\$7,000,555</u></u>	<u><u>\$6,654,328</u></u>

See notes to condensed consolidated financial statements (unaudited).

Item 1. Financial Statements (Continued)

TEXTRON FINANCIAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
SIX MONTHS ENDED JUNE 30, 2003 AND 2002
(Unaudited)

	<u>2003</u>	<u>2002</u>
	(In thousands)	
Cash flows from operating activities:		
Net income before cumulative effect of change in accounting principle	\$ 32,596	\$ 32,712
Adjustments to reconcile income to net cash provided by operating activities:		
Provision for losses	60,921	55,386
Deferred income tax provision	22,232	25,765
Depreciation	16,436	14,338
Increase (decrease) in accrued interest and other liabilities	6,053	(44,431)
Amortization	5,190	4,942
Noncash gains on securitizations	(5,381)	(19,238)
Other	(3,811)	5,324
Net cash provided by operating activities	<u>134,236</u>	<u>74,798</u>
Cash flows from investing activities:		
Finance receivables originated or purchased	(4,614,766)	(4,300,740)
Finance receivables repaid	4,002,420	3,632,522
Proceeds from receivable sales, including securitizations	449,788	355,633
Proceeds from disposition of operating leases and other assets	48,605	32,677
Purchase of assets for operating leases	(28,324)	(31,294)
Proceeds from sale of repossessed assets and real estate owned	21,788	3,594
Other capital expenditures	(9,259)	(12,616)
Other investments	<u>50,561</u>	<u>20,727</u>
Net cash used in investing activities	(79,187)	(299,497)
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	814,393	1,294,829
Principal payments on long-term debt	(460,180)	(737,900)
Net (decrease) increase in commercial paper	(320,253)	319,863
Net increase (decrease) in other short-term debt	14,826	(546,841)
Principal payments on nonrecourse debt	(44,481)	(43,624)
Net decrease in amounts due to Textron Inc.	(66)	(5,065)
Capital contributions from Textron Inc.	4,505	4,505
Dividends paid to Textron Inc.	<u>(39,505)</u>	<u>(57,505)</u>
Net cash (used in) provided by financing activities	(30,761)	228,262
Effect of exchange rate changes on cash	<u>60</u>	<u>(1,477)</u>
Net increase in cash	<u>24,348</u>	<u>2,086</u>
Cash and equivalents at beginning of period	<u>21,287</u>	<u>18,489</u>
Cash and equivalents at end of period	<u>\$ 45,635</u>	<u>\$ 20,575</u>

See notes to condensed consolidated financial statements (unaudited).

Item 1. Financial Statements (Continued)**TEXTRON FINANCIAL CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDER'S EQUITY
(Unaudited)**

	<u>Common Stock</u>	<u>Capital Surplus</u>	<u>Investment In Parent Company Pref. Stock</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Retained Earnings</u>	<u>Total</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	—	—	—	(3,552)	—	(3,552)
Other comprehensive income	—	—	—	4,156	—	4,156
Comprehensive income	—	—	—	—	—	64,462
Capital contributions from Textron Inc.	—	9,010	—	—	—	9,010
Dividends to Textron Inc. . . .	—	(9,010)	—	—	(53,000)	(62,010)
Balance December 28, 2002 . . .	250	573,676	(25,000)	(14,637)	486,528	1,020,817
Comprehensive income:						
Net income	—	—	—	—	32,596	32,596
Other comprehensive income, net of income taxes:						
Unrealized net gains on interest-only securities	—	—	—	13,357	—	13,357
Unrealized net gains on hedge contracts	—	—	—	11,166	—	11,166
Foreign currency translation adjustments	—	—	—	666	—	666
Other comprehensive income	—	—	—	25,189	—	25,189
Comprehensive income	—	—	—	—	—	57,785
Capital contributions from Textron Inc.	—	4,505	—	—	—	4,505
Dividends to Textron Inc. . . .	—	(4,505)	—	—	(35,000)	(39,505)
Balance June 30, 2003	<u>\$250</u>	<u>\$573,676</u>	<u>\$(25,000)</u>	<u>\$ 10,552</u>	<u>\$484,124</u>	<u>\$1,043,602</u>

See notes to condensed consolidated financial statements (unaudited).

TEXTRON FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1. Basis of Presentation

The financial statements should be read in conjunction with the financial statements included in Textron Financial Corporation's Annual Report on Form 10-K for the year ended December 28, 2002. The accompanying unaudited consolidated financial statements include the accounts of Textron Financial Corporation (Textron Financial or the Company) and its subsidiaries. All significant intercompany transactions are eliminated. The consolidated financial statements are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of Textron Financial's consolidated financial position at June 30, 2003 and December 28, 2002, and its consolidated results of operations and cash flows for each of the respective three- and six-month periods ended June 30, 2003 and 2002. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full year. Certain prior balances have been reclassified to conform to the current presentation.

Note 2. Other Income

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30,</u> <u>2003</u>	<u>June 30,</u> <u>2002</u>	<u>June 30,</u> <u>2003</u>	<u>June 30,</u> <u>2002</u>
	(In thousands)			
Securitization gains	\$11,122	\$11,643	\$15,868	\$19,238
Servicing fees	8,047	6,982	15,471	12,498
Investment income	1,957	5,920	6,695	10,385
Prepayment gains	3,312	3,157	6,025	4,868
Late charges	2,231	2,743	4,483	5,018
Syndication gains	1,217	2,423	2,137	3,918
Other	<u>4,090</u>	<u>3,525</u>	<u>12,996</u>	<u>12,335</u>
Total other income	<u>\$31,976</u>	<u>\$36,393</u>	<u>\$63,675</u>	<u>\$68,260</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. Allowance for Losses on Receivables

	<u>Six Months</u> <u>Ended</u> <u>June 30,</u> <u>2003</u>	<u>Twelve Months</u> <u>Ended</u> <u>December 28,</u> <u>2002</u>
		(In thousands)
Balance at beginning of period	\$166,510	\$143,756
Provision for losses	60,921	138,542
Receivable charge-offs	(68,662)	(138,862)
Recoveries	6,303	10,971
Acquisitions and other	—	12,103
Balance at end of period	<u>\$165,072</u>	<u>\$166,510</u>

Note 4. Managed and Serviced Finance Receivables

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

Item 1. Financial Statements (Continued)**TEXTRON FINANCIAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) — (Continued)**

	<u>June 30,</u> <u>2003</u>	<u>December 28,</u> <u>2002</u>
	(In thousands)	
Total managed and serviced finance receivables	\$ 9,851,838	\$ 9,395,778
Third-party portfolio servicing	(711,520)	(515,546)
Nonrecourse participations	(582,425)	(435,393)
SBA sales agreements	<u>(51,961)</u>	<u>(55,913)</u>
Total managed finance receivables	8,505,932	8,388,926
Securitized receivables	<u>(2,486,849)</u>	<u>(2,633,276)</u>
Owned finance receivables	<u>\$ 6,019,083</u>	<u>\$ 5,755,650</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, third-party securitization servicing, as well as private label bank and leasing company portfolio servicing.

Owned receivables include approximately \$85 million of finance receivables that were unfunded at June 30, 2003, primarily as a result of holdback arrangements. The corresponding liability is included in Accrued interest and other liabilities on Textron Financial's Condensed Consolidated Balance Sheets.

Note 5. 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 cost. 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.

The Company suspends the accrual of interest income 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 principal. The Company had \$199.3 million of nonaccrual finance receivables at June 30, 2003, compared to \$181.6 million at December 28, 2002. Nonaccrual finance receivables resulted in Textron Financial's revenues being reduced by approximately \$8.9 million and \$7.4 million for the first six months of 2003 and 2002, respectively. No interest income was recognized using the cash basis method. Excluding homogeneous loan portfolios and finance leases, the Company had impaired loans of \$145.1 million and \$122.1 million at June 30, 2003 and December 28, 2002, respectively. Impaired loans with identified reserve requirements were \$89.8 million and \$109.9 million at June 30, 2003 and December 28, 2002, respectively. The allowance for losses on receivables related to impaired loans with identified reserve requirements was \$39.8 million and \$32.7 million at June 30, 2003 and December 28, 2002, respectively. The average recorded investment in impaired loans during the first six months of 2003 was \$130.6 million, compared to \$84.2 million in the corresponding period in 2002.

Item 1. Financial Statements (Continued)**TEXTRON FINANCIAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) — (Continued)****Note 6. 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 Condensed 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.

Note 7. Other Assets

	<u>June 30, 2003</u>	<u>December 28, 2002</u>
	(In thousands)	
Retained interests in securitizations	\$257,636	\$257,147
Investment in equipment residuals	115,778	115,394
Interest-only securities	79,042	92,798
Fixed assets — net	49,041	50,196
Other long-term investments	41,092	24,104
Repossessed assets and properties	17,329	36,234
Other	<u>138,286</u>	<u>32,130</u>
Total other assets	<u>\$698,204</u>	<u>\$608,003</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.

Item 1. Financial Statements (Continued)**TEXTRON FINANCIAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) — (Continued)****Note 8. Debt and Credit Facilities**

	<u>June 30, 2003</u>	<u>December 28, 2002</u>
	(In thousands)	
Short-term debt:		
Commercial paper	\$ 552,144	\$ 872,397
Other short-term debt	<u>58,781</u>	<u>43,955</u>
Total short-term debt	610,925	916,352
Long-term debt:		
2.75% — 5.95% notes; due 2004 to 2007	1,464,801	1,152,682
6.00% — 6.84% notes; due 2003 to 2009	630,214	595,836
7.13% note; due 2004	599,130	598,827
7.25% note; due 2007	29,685	25,718
7.37% notes; due 2003	213,000	213,000
Variable rate notes; due 2003 to 2007	<u>1,446,691</u>	<u>1,337,206</u>
Total long-term debt	<u>4,383,521</u>	<u>3,923,269</u>
Total debt	<u>\$4,994,446</u>	<u>\$4,839,621</u>

The weighted average interest rates on short-term borrowings have been determined by relating the annualized interest cost to the daily average dollar amounts outstanding. The combined weighted average interest rate was 1.56% during the six months ended June 30, 2003, and 1.55% at June 30, 2002.

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 2.30% at June 30, 2003.

The fair value adjustment to designated fixed rate debt in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," was \$86 million and \$67 million at June 30, 2003 and December 28, 2002, respectively.

Effective July 28, 2003, Textron Financial renewed and extended its bank lines of credit. The Company has 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 June 30, 2003, were \$925 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 June 30, 2003, the Company has fully used the committed portion of the facility in addition to borrowing CAD 13 million under the uncommitted portion of the facility. Textron Financial also has a \$25 million multi-currency facility, of which \$13 million remains unused at June 30, 2003. Both the Canadian and multi-currency facilities expire in the third quarter of 2003. Textron Financial generally pays fees in support of these lines.

Through its subsidiary, Textron Financial Canada Funding Corp. (Textron Canada Funding), the Company may periodically issue 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.

Item 1. Financial Statements (Continued)**TEXTRON FINANCIAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) — (Continued)**

Securitizations are an important source of liquidity for Textron Financial and involve the periodic transfer of finance receivables to qualified special purpose trusts. At June 30, 2003 and December 28, 2002, the outstanding amount of debt issued by these qualified special purpose trusts was \$2.2 billion and \$2.3 billion, respectively.

The terms of certain of the Company's loan agreements and credit facilities, under the most restrictive covenant, limit the payment of dividends to \$442 million at June 30, 2003. In the first six months of 2003, Textron Financial declared and paid dividends of \$39.5 million.

Note 9. Textron Financial and Litchfield Obligated Mandatory Redeemable Preferred Securities of Trust Subsidiary Holding Solely Litchfield Junior Subordinated Debentures

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 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.

Item 1. Financial Statements (Continued)**TEXTRON FINANCIAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) — (Continued)****Note 10. Accumulated Other Comprehensive Income (Loss) and Comprehensive Income**

Accumulated other comprehensive income (loss) is as follows:

	<u>Six Months Ended</u>	
	<u>June 30,</u> <u>2003</u>	<u>June 30,</u> <u>2002</u>
	(In thousands)	
Beginning of period	\$(14,637)	\$(18,793)
Net deferred gain (loss) on interest-only securities, net of income taxes of \$8,014 and income tax benefit of \$1,042, respectively	13,357	(1,736)
Net deferred gain on hedge contracts, net of income taxes of \$6,043 and \$647, respectively	10,071	1,079
Amortization of deferred loss on terminated hedge contracts, net of income taxes of \$657 and \$824, respectively	1,095	1,373
Foreign currency translation adjustments	<u>666</u>	<u>(3,375)</u>
End of period	<u>\$ 10,552</u>	<u>\$ (21,452)</u>

Comprehensive income is summarized below:

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30,</u> <u>2003</u>	<u>June 30,</u> <u>2002</u>	<u>June 30,</u> <u>2003</u>	<u>June 30,</u> <u>2002</u>
	(In thousands)			
Net income	\$17,049	\$18,536	\$32,596	\$17,340
Other comprehensive income (loss)	<u>20,334</u>	<u>(4,188)</u>	<u>25,189</u>	<u>(2,659)</u>
Comprehensive income	<u>\$37,383</u>	<u>\$14,348</u>	<u>\$57,785</u>	<u>\$14,681</u>

Note 11. 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. While the Company believes that it has good defenses to any Government or potential consumer litigation, it entered into settlement discussions with the DOJ during the second quarter of 2003 to resolve the entire matter. While the outcome of the settlement discussions with the DOJ is uncertain at this time, the Company believes that it is reasonably possible that this matter will be resolved for less than \$5 million.

Textron Financial and Litchfield, together with other third parties, are currently defending a class action arising from Litchfield's extension of credit facilities to a third party. The plaintiffs in the class action are seeking compensatory and punitive damages in excess of \$20 million from all the defendants. On July 16, 2003, the Company's motion to dismiss certain counts within the class action was denied and the judge entered a preliminary ruling against the Company. The Company is aggressively defending this litigation and believes that a substantial part of any settlement or judgment would be covered by insurance. The Company is not able to predict the outcome of this action at this time.

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

Item 1. Financial Statements (Continued)**TEXTRON FINANCIAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) — (Continued)**

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 12. New Accounting Pronouncements

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" (FIN 46). FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. Management is currently evaluating the impact of the adoption of FIN 46 and does not anticipate that it will have a material effect on Textron Financial's results of operations or financial position.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," which amended SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 149 amends and clarifies the accounting and reporting for derivative instruments, including embedded derivatives, and for hedging activities. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. Management is currently evaluating the impact of the adoption of SFAS No. 149 and does not anticipate that it will have a material effect on Textron Financial's results of operations or financial position.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS 150 requires that an issuer classify certain financial instruments as liabilities. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. Upon implementation, Textron Financial will report its obligated mandatory redeemable preferred securities as a liability and all related expenses as a component of income before income taxes. See Note 9 for further discussion.

Note 13. Financial Information about Industry Segments

During the third quarter of 2002, the Company made a strategic decision to realign its business units into seven 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 that includes franchise finance, media finance and small business finance in addition to liquidating portfolios related to a strategic realignment of the Company's business and product lines in 2001. As a result of these segment changes, the financial information for June 30, 2002, has been recast reflecting the realignment of the segments.

Item 1. Financial Statements (Continued)**TEXTRON FINANCIAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) — (Continued)**

	Three Months Ended		Six Months Ended	
	June 30, 2003	June 30, 2002	June 30, 2003	June 30, 2002
	(In thousands)			
Revenues				
Distribution Finance	\$ 38,248	\$ 24,349	\$ 75,648	\$ 43,810
Golf Finance	21,716	17,495	41,304	33,423
Resort Finance	21,270	21,936	40,224	44,318
Aircraft Finance	19,051	20,078	37,802	43,286
Asset-Based Lending	14,937	16,367	29,307	31,291
Structured Capital	8,363	8,397	17,177	16,909
Other	31,548	40,400	64,399	80,061
Total revenues	<u>\$155,133</u>	<u>\$149,022</u>	<u>\$305,861</u>	<u>\$293,098</u>
Income (loss) before income taxes, distributions on preferred securities and cumulative effect of change in accounting principle (1) (2)				
Distribution Finance	\$ 15,694	\$ 8,637	\$ 28,953	\$ 15,285
Golf Finance	8,115	4,197	14,164	8,279
Resort Finance	5,230	8,968	11,431	19,351
Aircraft Finance	2,471	361	973	2,745
Asset-Based Lending	5,141	5,099	8,746	5,993
Structured Capital	3,016	3,338	6,872	8,967
Other	(13,152)	(1,415)	(20,749)	(8,553)
Total income before income taxes, distributions on preferred securities and cumulative effect of change in accounting principle	<u>\$ 26,515</u>	<u>\$ 29,185</u>	<u>\$ 50,390</u>	<u>\$ 52,067</u>
June 30, 2003 December 28, 2002				
(In thousands)				
Finance assets (3)				
Aircraft Finance			\$1,299,740	\$1,216,144
Resort Finance			1,135,704	1,052,734
Golf Finance			942,416	964,271
Distribution Finance			851,131	841,118
Structured Capital			583,574	581,207
Asset-Based Lending			484,699	521,067
Other			<u>1,454,558</u>	<u>1,359,841</u>
Total finance assets			<u>\$6,751,822</u>	<u>\$6,536,382</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

Item 1. Financial Statements (Continued)**TEXTRON FINANCIAL CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) — (Continued)**

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 other long-term investments (some of which are classified in Other assets on Textron Financial's Condensed Consolidated Balance Sheets).

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**TEXTROM FINANCIAL CORPORATION****Financial Condition***Liquidity and Capital Resources*

Textron Financial Corporation (Textron Financial or the Company) uses a broad base of financial resources for its liquidity and capital needs. Cash is provided from operations and several sources of borrowings, including the issuance of commercial paper and other short-term debt, and sales of medium and long-term debt in the U.S. and foreign public and private markets. For liquidity purposes, Textron Financial has a policy of maintaining sufficient unused lines of credit to support its outstanding commercial paper. Textron Financial has bank lines of credit of \$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, on July 28, 2003, Textron Inc. (Textron) amended its credit facilities to permit Textron Financial to borrow under the facilities. None of these lines of credit were used at June 30, 2003, 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 June 30, 2003, Textron Financial had fully used the committed portion of the facility in addition to borrowing CAD 13 million under the uncommitted portion of the facility. Textron Financial also has a \$25 million multi-currency facility, of which \$13 million remains unused at June 30, 2003. Both the Canadian and multi-currency facilities expire in the third quarter of 2003. The Company expects to renew these facilities prior to expiration. Lines of credit not reserved as support for commercial paper or utilized for letters of credit were \$925 million at June 30, 2003, compared to \$716 million at December 28, 2002. Further, Textron had unused and unreserved primary lines of credit of \$1.5 billion at June 30, 2003. The increase in the unreserved portion of Textron Financial's lines of credit is principally attributable to the securitization of golf equipment receivables, the sale of franchise finance receivables and issuance of term notes, partially offset by the voluntary termination and liquidation of a revolving securitization conduit through a receivable repurchase and finance receivable growth.

Under a shelf registration statement filed with the Securities and Exchange Commission, Textron Financial may issue public debt securities in one or more offerings up to a total maximum offering of \$3.0 billion. Under this facility, Textron Financial issued \$816 million of term notes during the first six months of 2003 that mature in 2005 and 2006. The proceeds from these issuances were used to refinance maturing commercial paper and long-term debt at par. At June 30, 2003, Textron Financial had \$329 million available under this facility.

Securitizations are an important source of funding for the Company. During the first six months of 2003, Textron Financial received net proceeds of \$225 million, \$79 million, \$38 million and \$9 million from the securitizations of Distribution Finance receivables (on a revolving basis), golf equipment receivables, Aircraft Finance receivables and Resort Finance receivables, respectively. These securitizations provided Textron Financial with an alternate source of liquidity. Textron used the proceeds from the securitizations to retire commercial paper. Cash collections on current and prior period securitization gains were \$22.2 million and \$26.0 million, for the six-month periods ended June 30, 2003 and June 30, 2002, respectively. Textron Financial anticipates that it will enter into additional securitization transactions during the remainder of 2003.

During the first quarter of 2003, Textron Financial's short and long-term debt credit ratings were downgraded from F1 to F2 and from A to A-, respectively, by Fitch and the Company's long-term debt was placed on CreditWatch with negative implications by Standard & Poor's. The economic environment and its potential impact on the financial performance of the Company's finance receivable portfolios were listed as contributing factors. While the actions of the rating agencies caused the Company's cost of capital to increase, it did not result in any loss of access to capital. In the second quarter of 2003, Standard & Poor's affirmed the Company's short and long-term debt ratings at A2 and A-, respectively, with a stable outlook. Further downgrades in Textron Financial's ratings could increase borrowing spreads or limit its access to the commercial paper, securitization and long-term debt markets. In addition, Textron Financial's \$1.5 billion

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

revolving bank line of credit agreements contain certain financial covenants that Textron Financial needs to comply with to maintain its ability to borrow under the facilities. Textron Financial was in full compliance with such covenants at June 30, 2003.

Textron Financial believes that it has adequate credit facilities and access to credit markets to meet its long-term financing needs.

Cash flows provided by operations were \$134 million during the first six months of 2003, compared to \$75 million in the corresponding period last year. The increase was principally due to the timing of payments of accrued interest and other liabilities.

Cash flows used in investing activities were funded primarily from the collection of receivables and through the issuance of debt. The increase in proceeds from receivable sales primarily reflects the sale of a franchise portfolio (\$95 million).

Textron Financial declared and paid dividends to Textron of \$39.5 million during the first six months of 2003, compared to \$57.5 million of dividends declared and paid during the corresponding period of 2002. The decrease in 2003 was due to the retention of capital to support finance receivable growth.

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 83% at June 30, 2003 and December 28, 2002. Textron Financial's ratio of earnings to fixed charges was 1.54x for both the six months ended June 30, 2003 and the corresponding period in 2002. Commercial paper and Other short-term debt as a percentage of total debt was 12% at June 30, 2003, compared to 19% at December 28, 2002. Textron Financial has a policy of matching the duration of its assets with its debt. Changes in short and long-term debt are directly related to the duration of Textron Financial's assets and liabilities.

Finance Assets

Textron Financial's financing activities are confined almost exclusively to secured lending and leasing to commercial markets. Management believes that the portfolio avoids excessive concentration of risk through diversification across geographic regions, industries and types of collateral, and among borrowers.

Total finance assets, which includes 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 other long-term investments (some of which are classified in Other assets on Textron Financial's Condensed Consolidated Balance Sheets), were \$6.8 billion at June 30, 2003, up 3% from \$6.5 billion at December 28, 2002. The increase in finance assets was mostly due to small business finance within the Other segment (\$172 million), which was primarily the result of the liquidation of a revolving securitization conduit, Aircraft Finance (\$84 million) and Resort Finance (\$83 million).

Finance receivable additions for the first six months of 2003 were \$4.6 billion, compared to \$4.3 billion in the corresponding period last year. The majority of the growth in finance receivable additions was from Distribution Finance (\$419 million).

Nonperforming Assets

Nonperforming assets, which includes independent and nonrecourse captive finance assets, as a percentage of finance assets decreased to 3.21% (\$217 million) at June 30, 2003, compared to 3.33% (\$218 million) at December 28, 2002. The \$1 million decrease in nonperforming assets at June 30, 2003, compared to December 28, 2002, was due to decreases in Aircraft Finance (\$9 million), Asset-Based Lending (\$8 million) and Distribution Finance (\$5 million) segments, mostly offset by an increase in the Other segment (\$12 million), Resort Finance (\$8 million) and Golf Finance (\$1 million) segments. The increases in the Other segment primarily include franchise finance (\$6 million) and small business finance (\$6 million).

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

The Other segment represents 24% of owned receivables and 47% of nonperforming assets at June 30, 2003. The Company believes that nonperforming assets will generally be in the range of 2% to 4% of finance assets depending on economic conditions.

The allowance for losses on receivables was \$165.1 million at June 30, 2003, as compared to \$166.5 million at December 28, 2002. The allowance for losses on receivables as a percentage of total finance receivables was 2.7% at June 30, 2003, compared to 2.9% at December 28, 2002 (3.0% and 3.1%, respectively, excluding captive receivables with recourse to Textron). The allowance for losses on receivables as a percentage of nonaccrual finance receivables was 83% at June 30, 2003, as compared to 92% at December 28, 2002. The decrease in the percentage represents an increase in nonaccrual loans (\$199 million at June 30, 2003, as compared to \$182 million at December 28, 2002) that are supported by strong collateral values.

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 interest-sensitive assets with interest-sensitive liabilities limits Textron Financial's risk to changes in interest rates, and includes entering into interest rate exchange agreements. At June 30, 2003, interest-sensitive assets in excess of interest-sensitive liabilities were \$1.2 billion, net of \$1.6 billion of interest rate exchange agreements on long-term debt and \$265 million of interest rate exchange agreements on finance receivables. However, classified within interest-sensitive assets are approximately \$850 million of floating rate loans with rate floors that are generally 173 basis points above the rate that would otherwise be applicable with reference to the benchmark index (predominately the prime rate). As a consequence, these assets have become interest-insensitive, and will remain so until the prime rate increases by more than 173 basis points.

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 or LIBOR. 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 June 30, 2003, indicates that an increase in interest rates of 100 basis points would have a beneficial impact on Textron Financial's net income and cash flows for the following twelve-month period, whereas, a decrease in interest rates of 100 basis points reduces Textron Financial's net income and cash flow by \$0.5 million for the following twelve-month period, including the effects of the rate floors.

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 a prudent balance between floating and fixed rate debt. 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.

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

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

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 exposure to changes in currency rates. The notional amounts of outstanding foreign currency forward exchange contracts were nominal.

Results of Operations***For the three and six months ended June 30, 2003 vs. June 30, 2002*****Revenues*****Three months ended June 30, 2003 vs. June 30, 2002***

Second quarter 2003 revenues increased by \$6.1 million, or 4.1%, compared to the corresponding period in 2002. The increase in revenues principally reflects higher finance charges and discounts (\$11.4 million) due to a higher level of average finance receivables (\$9.4 million) and higher receivable pricing (\$2.0 million). The higher level of average finance receivables (\$532 million) was primarily due to growth in the Distribution Finance segment. This increase was partially offset by lower Other income (\$4.4 million), primarily due to lower investment income (\$4.0 million).

Six months ended June 30, 2003 vs. June 30, 2002

Revenues for the first six months of 2003 increased by \$12.8 million, or 4.4%, compared to the corresponding period in 2002. The increase in revenues principally reflects higher finance charges and discounts (\$17.5 million) largely due to a higher level of average finance receivables (\$13.4 million) and higher receivable pricing (\$4.1 million). The higher level of average finance receivables (\$397 million) was primarily due to growth in the Distribution Finance segment. This increase was partially offset by lower Other income (\$4.6 million), primarily due to lower investment income (\$3.7 million), securitization gains (\$3.4 million) and syndication income (\$1.8 million), offset by higher servicing fees (\$3.0 million) and prepayment gains (\$1.2 million).

Interest Expense***Three months ended June 30, 2003 vs. June 30, 2002***

Second quarter 2003 interest expense decreased by \$1.7 million, or 3.4%, on 6.7% higher average debt outstanding. The lower interest expense reflects a decrease in the average borrowing rate to 3.51% from 3.88%, primarily attributable to a lower interest rate environment and the maturity of higher cost debt.

Six months ended June 30, 2003 vs. June 30, 2002

Interest expense for the first six months of 2003 decreased by \$2.7 million, or 2.8%, on 4.2% higher average debt outstanding. The lower interest expense reflects a decrease in the average borrowing rate to 3.58% from 3.83%, primarily attributable to a lower interest rate environment and the maturity of higher cost debt.

Interest Margin

Textron Financial's earnings are influenced by the interest margin earned on finance receivables (i.e., revenues earned less interest expense on borrowings and operating lease depreciation).

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)*Three months ended June 30, 2003 vs. June 30, 2002*

Interest margin increased \$7.4 million, and decreased 8 basis points (6.65% versus 6.73%) for the second quarter of 2003 compared to the corresponding period in 2002. The contraction in the interest margin percentage was primarily due to lower other income.

Six months ended June 30, 2003 vs. June 30, 2002

Interest margin increased \$14.1 million, or 5 basis points (6.76% versus 6.71%) for the first six months of 2003 compared to the corresponding period in 2002. The increase in interest margin was primarily due to higher finance charges and discounts from higher average finance receivables, higher receivable pricing and a lower borrowing cost, partially offset by lower other income.

Selling and Administrative Expenses*Three months ended June 30, 2003 vs. June 30, 2002*

Selling and administrative expenses of \$46.5 million increased \$3.9 million in the second quarter of 2003 compared to the corresponding period in 2002. The increase in 2003 principally reflects costs related to growth in managed and serviced finance receivables (\$1.5 million), and higher data processing (\$1.5 million), legal and collection (\$0.9 million) and telecommunication (\$0.7 million) expenses. Selling and administrative expenses as a percentage of average managed and serviced finance receivables were 1.91% (on an annualized basis) in the second quarter of 2003, compared to 1.81% in 2002.

Six months ended June 30, 2003 vs. June 30, 2002

Selling and administrative expenses of \$93.8 million increased \$10.2 million in the first six months of 2003 compared to the corresponding period in 2002. The increase in 2003 principally reflects higher legal and collection (\$3.5 million), data processing (\$1.9 million) and telecommunication (\$1.4 million) expenses as well as costs related to growth in managed and serviced finance receivables (\$2.4 million). Selling and administrative expenses as a percentage of average managed and serviced finance receivables were 1.96% (on an annualized basis) in the first six months of 2003, compared to 1.79% in 2002.

Provision for Losses*Three months ended June 30, 2003 vs. June 30, 2002*

The provision for losses of \$31.2 million for the second quarter of 2003 increased from \$25.0 million for the corresponding period in 2002. The increase reflects higher net charge-offs (\$12.9 million), partially offset by a reduction in the allowance for losses on receivables as a result of charge-offs related to previously reserved accounts. The increase in net charge-offs was primarily related to the Other segment (\$4.5 million), Aircraft Finance (\$3.1 million), Distribution Finance (\$2.4 million) and Resort Finance (\$2.2 million) segments.

Six months ended June 30, 2003 vs. June 30, 2002

The provision for losses of \$60.9 million for the first six months of 2003 increased from \$55.4 million for the corresponding period in 2002. The increase reflects higher net charge-offs (\$12.6 million), partially offset by a reduction in the allowance for losses on receivables as a result of charge-offs related to previously reserved accounts. The increase in net charge-offs was primarily related to Distribution Finance (\$5.1 million), Aircraft Finance (\$4.3 million), Resort Finance (\$2.1 million) and Golf Finance (\$2.0 million) segments.

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.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**Operating Results by Segment**

Six months ended June 30, 2003 vs. June 30, 2002

Segment income below represents income before special charges, income taxes, distributions on preferred securities and cumulative effect of change in accounting principle.

Distribution Finance income increased \$13.7 million reflecting higher interest margin (\$27.2 million), offset by higher operating expenses (\$8.7 million) and higher provision for losses (\$4.8 million) largely related to growth in finance receivables. The higher interest margin was principally due to higher average finance assets (\$419 million), higher receivable pricing and higher other income.

Golf Finance income increased \$5.9 million reflecting higher interest margin (\$7.4 million) primarily due to higher other income (\$5.1 million) and higher average finance assets (\$46 million). This increase in interest margin was partially offset by higher operating expenses (\$1.6 million).

Resort Finance income decreased \$7.9 million reflecting lower interest margin (\$4.3 million), higher operating expenses (\$2.1 million) and higher loss provision (\$1.5 million). The decrease in interest margin largely reflects lower pricing despite higher average finance assets (\$118 million).

Aircraft Finance income decreased by \$1.8 million reflecting lower interest margin (\$2.4 million) and higher operating expenses (\$1.7 million), partially offset by a lower provision for losses (\$2.3 million). The decrease in interest margin is primarily due to lower other income (\$1.1 million).

Asset-Based Lending income increased \$2.7 million primarily reflecting lower provision for loan losses (\$4.6 million), partially offset by lower interest margin (\$1.5 million).

Structured Capital income decreased \$2.1 million primarily reflecting higher provision for loan losses (\$2.2 million).

Other segment income decreased \$12.2 million reflecting lower interest margin (\$12.5 million) and a higher provision for losses (\$4.0 million), partially offset by lower operating expenses (\$4.3 million). The lower interest margin largely reflects lower other income (\$12.9 million).

Income Before Cumulative Effect of Change in Accounting Principle

Three months ended June 30, 2003 vs. June 30, 2002

Income before cumulative effect of change in accounting principle for the second quarter was \$17.0 million, \$1.5 million or 8.0% lower than the corresponding period in 2002. The decrease reflects a higher provision for losses (\$6.2 million) and higher selling and administrative expenses (\$3.9 million), partially offset by a higher interest margin (\$7.4 million) and a lower effective tax rate.

Six months ended June 30, 2003 vs. June 30, 2002

Income before cumulative effect of change in accounting principle for the first six months of 2003 was \$32.6 million, \$0.1 million lower than the corresponding period in 2002. The decrease reflects higher selling and administrative expenses (\$10.2 million) and a higher provision for losses (\$5.5 million), mostly offset by a higher interest margin (\$14.1 million) and a lower effective tax rate.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**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. While the Company believes that it has good defenses to any Government or potential consumer litigation, it entered into settlement discussions with the DOJ during the second quarter of 2003 to resolve the entire matter. While the outcome of the settlement discussions with the DOJ is uncertain at this time, the Company believes that it is reasonably possible that this matter will be resolved for less than \$5 million.

Textron Financial and Litchfield, together with other third parties, are currently defending a class action arising from Litchfield's extension of credit facilities to a third party. The plaintiffs in the class action are seeking compensatory and punitive damages in excess of \$20 million from all the defendants. On July 16, 2003, the Company's motion to dismiss certain counts within the class action was denied and the judge entered a preliminary ruling against the Company. The Company is aggressively defending this litigation and believes that a substantial part of any settlement or judgment would be covered by insurance. The Company is not able to predict the outcome of this action at this time.

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.

Selected Financial Ratios

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 30, 2003</u>	<u>June 30, 2002</u>	<u>June 30, 2003</u>	<u>June 30, 2002</u>
Net interest margin as a percentage of average net investment (1)	6.65%	6.73%	6.76%	6.71%
Return on average equity (2)	6.68%	7.55%	6.44%	6.63%
Return on average assets (3)	0.94%	1.10%	0.93%	0.98%
Ratio of earnings to fixed charges	1.55x	1.59x	1.54x	1.54x
Selling and administrative expenses as a percentage of average managed and serviced finance receivables (4)	1.91%	1.81%	1.96%	1.79%
Operating efficiency ratio (5)	44.6%	44.0%	45.7%	43.7%
Net charge-offs as a percentage of average finance receivables	2.20%	1.51%	2.03%	1.73%
			<u>June 30, 2003</u>	<u>December 28, 2002</u>
60+ days contractual delinquency as a percentage of finance receivables (6)			3.23%	2.88%
Nonperforming assets as a percentage of finance assets (7)			3.21%	3.33%
Allowance for losses on receivables as a percentage of finance receivables			2.74%	2.89%
Allowance for losses on receivables as a percentage of nonaccrual finance receivables			82.8%	91.7%
Total debt to tangible shareholder's equity (8)			5.9x	5.7x

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

- (1) 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.
- (2) Return on average equity excludes the cumulative effect of change in accounting principle.
- (3) Return on average assets excludes the cumulative effect of change in accounting principle.
- (4) Average managed and serviced finance receivables include owned receivables, receivables serviced under securitizations, participations and third-party portfolio servicing agreements.
- (5) Operating efficiency ratio is selling and administrative expenses divided by net interest margin.
- (6) 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.
- (7) 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 long-term investments (some of which are classified in Other assets on Textron Financial's Condensed Consolidated Balance Sheets). Nonperforming assets include independent and nonrecourse captive finance assets.
- (8) Tangible shareholder's equity equals Shareholder's equity, excluding Accumulated other comprehensive income or loss, less Goodwill.

New Accounting Pronouncements

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" (FIN 46). FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. Management is currently evaluating the impact of the adoption of FIN 46 and does not anticipate that it will have a material effect on Textron Financial's results of operations or financial position.

In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," which amended SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 149 amends and clarifies the accounting and reporting for derivative instruments, including embedded derivatives, and for hedging activities. SFAS No. 149 is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. Management is currently evaluating the impact of the adoption of SFAS No. 149 and does not anticipate that it will have a material effect on Textron Financial's results of operations or financial position.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS 150 requires that an issuer classify certain financial instruments as liabilities. SFAS 150 is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. Upon implementation, Textron Financial will report its obligated mandatory redeemable preferred securities as a liability and all related expenses as a component of income before income taxes. See Note 9 for further discussion.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (Continued)**Forward-looking Information**

Certain statements in this Form 10-Q 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) changes in worldwide economic and political conditions that impact interest and foreign exchange rates; (b) the occurrence of further downturns in customer markets to which Textron products are sold or supplied and financed or where Textron Financial offers financing; (c) the ability to control costs and successful implementation of various cost reduction programs; (d) the ability to maintain portfolio credit quality; (e) Textron Financial's access to debt financing at competitive rates; (f) access to equity in the form of retained earnings and capital contributions from Textron; and (g) uncertainty in estimating contingent liabilities and establishing reserves tailored to address such contingencies.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

For information regarding Textron Financial's Quantitative and Qualitative Disclosure About Market Risk, see "Interest Rate Sensitivity" and "Financial Risk Management" in Item 2 of this Form 10-Q.

Item 4. 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 fiscal quarter 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 fiscal quarter covered by this report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

TEXTRON FINANCIAL CORPORATION

Item 6. *Exhibits and Reports on Form 8-K*

(a) Exhibits

- 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). 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).
- 4.2 Indenture dated as of November 30, 2001, between Textron Financial Canada Funding Corp. and SunTrust Bank, guaranteed by Textron Financial Corporation. Incorporated by reference to Exhibit 4.2 to amendment No. 1 to Textron Financial Corporation's Registration Statement on Form S-3 (No. 333-72676).
- 12 Computation of Ratios of Earnings to Fixed Charges
- 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 Corporation have not been filed as exhibits to this Report because the authorized principal amount of any one such issues does not exceed 10% of the total assets of Textron Financial Corporation and its subsidiaries on a consolidated basis. Textron Financial Corporation agrees to furnish a copy of each such instrument to Commission upon request.

(b) Reports on Form 8-K

No reports on Form 8-K were filed during the quarter ended June 30, 2003.

SIGNATURES

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

Date: August 5, 2003

TEXTRON FINANCIAL CORPORATION

/s/ THOMAS J. CULLEN

Thomas J. Cullen
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)