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, 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 Incorporation or Organization)	**(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.

TEXTRON FINANCIAL CORPORATION

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PART I. FINANCIAL INFORMATION

Item 1. ***Financial Statements***

TEXTRON FINANCIAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
	(In thousands)			
Finance charges and discounts	$ 85,105	$104,637	$179,156	$208,396
Rental revenues on operating leases	7,031	6,306	13,574	14,019
Other income	44,800	31,589	78,347	60,163
Total revenues	136,936	142,532	271,077	282,578
Interest expense	34,092	45,072	72,556	88,775
Depreciation of equipment on operating leases	4,450	3,758	8,632	8,295
Net interest margin	98,394	93,702	189,889	185,508
Selling and administrative expenses	48,804	43,580	89,520	87,945
Provision for losses	13,835	26,034	33,637	50,036
Income from continuing operations before income taxes and distributions on preferred securities	35,755	24,088	66,732	47,527
Income taxes	11,584	8,180	21,652	15,982
Distributions on preferred securities (net of tax benefits of $184 and $368, respectively)	—	384	—	748
Income from continuing operations	24,171	15,524	45,080	30,797
Income from discontinued operations, net of income taxes	—	1,525	—	1,799
Net income	$ 24,171	$ 17,049	$ 45,080	$ 32,596

See notes to condensed consolidated financial statements (unaudited).

Item 1. ***Financial Statements (Continued)***

TEXTRON FINANCIAL CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	June 30, 2004	January 3, 2004
	(Dollars in thousands)	
Assets		
Cash and equivalents	$ 87,348	$ 357,307
Finance receivables, net of unearned income:		
Revolving loans	1,510,973	1,194,113
Installment contracts	1,250,092	1,396,466
Golf course and resort mortgages	945,398	777,979
Distribution finance receivables	791,909	944,522
Leveraged leases	512,832	513,227
Finance leases	350,006	308,940
Total finance receivables	5,361,210	5,135,247
Allowance for losses on receivables	(111,117)	(119,148)
Finance receivables — net	5,250,093	5,016,099
Equipment on operating leases — net	195,429	210,182
Goodwill	169,283	169,283
Other assets	515,778	579,972
Total assets	$6,217,931	$6,332,843
Liabilities and shareholder's equity		
Liabilities		
Accrued interest and other liabilities	$ 480,101	$ 479,115
Amounts due to Textron Inc.	23,000	21,525
Deferred income taxes	406,294	389,653
Debt	4,330,064	4,406,966
Junior subordinated debentures	—	26,421
Total liabilities	5,239,459	5,323,680
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	(10,447)	(1,676)
Retained earnings	439,993	461,913
Total shareholder's equity	978,472	1,009,163
Total liabilities and shareholder's equity	$6,217,931	$6,332,843

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, 2004 AND 2003
(Unaudited)

	2004	2003
	(In thousands)	
Cash flows from operating activities:		
Income from continuing operations	$ 45,080	$ 30,797
Adjustments to reconcile income from continuing operations to net cash provided by operating activities:		
Provision for losses	33,637	50,036
Deferred income tax provision	21,824	22,232
Depreciation	18,445	16,047
Amortization	5,539	5,190
(Decrease) increase in accrued interest and other liabilities	(100,980)	6,053
Noncash gains on securitizations and syndications	(5,582)	(5,381)
Other	3,398	(3,640)
Net cash provided by operating activities of continuing operations	21,361	121,334
Cash flows from investing activities:		
Finance receivables originated or purchased	(5,129,537)	(4,199,668)
Finance receivables repaid	4,707,421	3,782,633
Proceeds from receivable sales, including securitizations	247,669	449,788
Proceeds from disposition of operating leases and other assets	32,848	48,605
Purchase of assets for operating leases	(19,435)	(28,324)
Proceeds from disposition of repossessed assets and real estate owned	12,830	21,788
Other capital expenditures	(4,903)	(9,259)
Other investments	41,794	40,690
Net cash (used) provided by investing activities of continuing operations	(111,313)	106,253
Cash flows from financing activities:		
Proceeds from issuance of long-term debt	445,066	814,393
Principal payments on long-term debt	(550,066)	(460,180)
Redemption of junior subordinated debentures	(26,200)	—
Net increase (decrease) in commercial paper	57,445	(320,253)
Net increase in other short-term debt	445	14,826
Principal payments on nonrecourse debt	(39,999)	(44,481)
Net decrease in amounts due to Textron Inc.	—	(66)
Capital contributions from Textron Inc.	4,505	4,505
Dividends paid to Textron Inc.	(71,505)	(39,505)
Net cash used by financing activities of continuing operations	(180,309)	(30,761)
Effect of exchange rate changes on cash and equivalents	302	60
Net cash (used) provided by continuing operations	(269,959)	196,886
Net cash used by discontinued operations	—	(172,538)
Net (decrease) increase in cash and equivalents	(269,959)	24,348
Cash and equivalents at beginning of period	357,307	21,287
Cash and equivalents at end of period	$ 87,348	$ 45,635

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)

	Common Stock	Capital Surplus	Investment In Parent Company Pref. Stock	Accumulated Other Comprehensive Loss	Retained Earnings	Total
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	—	—	—	(3,452)	—	(3,452)
Other comprehensive income	—	—	—	12,961	—	12,961
Comprehensive income	—	—	—	—	—	93,346
Capital contributions from Textron Inc.	—	9,010	—	—	—	9,010
Dividends to Textron Inc.	—	(9,010)	—	—	(105,000)	(114,010)
Balance January 3, 2004	250	573,676	(25,000)	(1,676)	461,913	1,009,163
Comprehensive income:						
Net income	—	—	—	—	45,080	45,080
Other comprehensive loss, net of income tax benefit:						
Foreign currency translation adjustments	—	—	—	(594)	—	(594)
Unrealized net losses on hedge contracts	—	—	—	(1,404)	—	(1,404)
Unrealized net losses on interest-only securities	—	—	—	(6,773)	—	(6,773)
Other comprehensive loss	—	—	—	(8,771)	—	(8,771)
Comprehensive income	—	—	—	—	—	36,309
Capital contributions from Textron Inc.	—	4,505	—	—	—	4,505
Dividends to Textron Inc.	—	(4,505)	—	—	(67,000)	(71,505)
Balance June 30, 2004	$250	$573,676	$(25,000)	$(10,447)	$ 439,993	$ 978,472

See notes to condensed consolidated financial statements (unaudited).

TEXTRON FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

Note 1. Basis of Presentation

The condensed consolidated financial statements should be read in conjunction with the consolidated financial statements included in Textron Financial Corporation's Annual Report on Form 10-K for the year ended January 3, 2004. The accompanying condensed 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 condensed 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, 2004, and its consolidated results of operations and cash flows for each of the respective three- and six-month periods ended June 30, 2004 and 2003. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full year. Certain prior year balances have been reclassified to conform to the current year presentation.

Note 2. Other Income

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
	(In thousands)			
Securitization gains	$16,624	$11,122	$29,187	$14,943
Servicing fees	8,042	8,041	16,175	14,696
Prepayment income	5,110	3,258	7,687	5,922
Syndication income	4,048	1,217	5,170	2,133
Investment income	2,979	1,957	4,849	5,553
Late charges	1,769	2,091	3,631	4,262
Other	6,228	3,903	11,648	12,654
Total other income	$44,800	$31,589	$78,347	$60,163

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 included $4.1 million of severance costs, $1.5 million in asset impairment charges, $0.2 million in contract termination costs and $0.5 million in other associated costs.

The Company paid severance related benefits and other expenses of $6 million through June 30, 2004, which were charged against the restructuring reserve, leaving a balance in the reserve of $0.2 million. The

Company will pay the remaining restructuring costs in 2004. The detail of the reserve account for the six months ended June 30, 2004, is presented below.

	Severance Costs	Contractual Obligations	Other Associated Costs	Total
	(In thousands)			
Balance at January 3, 2004	$ 2,080	$ 191	$ 360	$ 2,631
Cash paid	(2,080)	(121)	(206)	(2,407)
Balance at June 30, 2004	$ —	$ 70	$ 154	$ 224

Note 4. Allowance for Losses on Receivables

	Six Months Ended June 30, 2004	Twelve Months Ended January 3, 2004
	(In thousands)	
Balance at beginning of period	$119,148	$ 144,907
Provision for losses	33,637	80,941
Charge-offs	(52,161)	(131,001)
Recoveries	8,543	13,776
Other	1,950	10,525
Balance at end of period	$111,117	$ 119,148

Note 5. Managed and Serviced Finance Receivables

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

	June 30, 2004	January 3, 2004
	(In thousands)	
Total managed and serviced finance receivables	$ 8,793,994	$ 8,533,659
Third-party portfolio servicing	(507,660)	(488,133)
Nonrecourse participations	(517,539)	(472,138)
SBA sales agreements	(44,480)	(48,837)
Total managed finance receivables	7,724,315	7,524,551
Securitized receivables	(2,036,706)	(1,981,398)
Other managed finance receivables	(326,399)	(407,906)
Owned finance receivables	$ 5,361,210	$ 5,135,247

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

Nonrecourse participations consist of undivided interests in loans originated by Textron Financial, primarily in the golf course and resort mortgage portfolios, which are sold to independent investors.

Owned receivables include approximately $83 million of finance receivables that were unfunded at June 30, 2004, 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 6. 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 collaterally 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 $141.5 million of nonaccrual finance receivables at June 30, 2004, compared to $152.0 million at January 3, 2004. Nonaccrual finance receivables resulted in Textron Financial's revenues being reduced by approximately $8.3 million and $8.9 million for the first six months of 2004 and 2003, respectively. No interest income was recognized using the cash basis method. Excluding homogeneous loan portfolios and finance leases, the Company had impaired loans of $93.1 million and $98.8 million at June 30, 2004 and January 3, 2004, respectively, which are on non-accrual status. Impaired loans with identified reserve requirements were $47.1 million and $47.4 million at June 30, 2004 and January 3, 2004, respectively. The allowance for losses on receivables related to impaired loans with identified reserve requirements was $14.3 million and $17.8 million at June 30, 2004 and January 3, 2004, respectively. The average recorded investment in impaired loans during the first six months of 2004 was $98.3 million compared to $130.6 million in the corresponding period in 2003. In addition, the Company identified loans that are considered impaired due to the significant modification of the original loan terms to reflect deferred principal payments, generally at market interest rates, but which continue to accrue interest income since full collection of principal and interest is not doubtful. The balance of these loans outstanding as of June 30, 2004 and January 3, 2004 were $15.7 million and $136.8 million, respectively.

Captive finance receivables with recourse that were 90 days or more delinquent amounted to $45 million and $41 million at June 30, 2004 and January 3, 2004, and were 12.5% and 9.6% of captive finance receivables with recourse, respectively. Revenues recognized on delinquent accounts with recourse were approximately $1.5 million on an average balance of $41.3 million and $3.2 million on an average balance of $67.7 million during the first six months of 2004 and 2003, respectively.

TEXTRON FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) — (Continued)

Note 7. Other Assets

	June 30, 2004	January 3, 2004
	(In thousands)	
Retained interests in securitizations	$169,006	$197,706
Investment in equipment residuals	92,258	109,182
Interest-only securities	61,565	72,505
Other long-term investments	68,997	55,960
Fixed assets — net	42,266	47,205
Repossessed assets and properties	6,305	10,039
Other	75,381	87,375
Total other assets	$515,778	$579,972

The Investment in equipment residuals represents the remaining equipment residual values associated principally with Textron golf and turf equipment lease payments that were securitized or sold 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 8. Debt and Credit Facilities

	June 30, 2004	January 3, 2004
	(In thousands)	
Short-term debt:		
Commercial paper	$ 554,301	$ 496,856
Other short-term debt	23,221	22,776
Total short-term debt	577,522	519,632
Long-term debt:		
5.65% — 5.95% notes; due 2004 to 2007	691,219	1,106,219
2.69% — 3.47% notes; due 2006 to 2007	554,823	511,195
6.00% — 6.84% notes; due 2005 to 2009	565,760	565,760
7.13% note; due 2004	600,000	600,000
7.25% note; due 2007	29,688	30,148
4.39% note; due 2004 to 2013	400,000	—
Variable rate notes; due 2004 to 2007	920,500	1,055,722
Gross long-term debt	3,761,990	3,869,044
Unamortized discount	(3,129)	(3,968)
Fair value adjustment (in accordance with SFAS No. 133)	(6,319)	22,258
Total long-term debt	3,752,542	3,887,334
Total debt	$4,330,064	$4,406,966

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 1.36% during the six months ended June 30, 2004, and 1.53% at June 30, 2004.

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 2.19% at June 30, 2004.

Effective July 26, 2004, Textron Financial renewed and extended its $500 million bank line of credit. The Company has committed bank lines of credit of $1.5 billion, of which $500 million expires in 2005 and $1.0 billion expires in 2008. The $500 million facility includes a one-year term out option, effectively extending its expiration into 2006. Textron Financial's lines of credit, not reserved as support for commercial paper or utilized for letters of credit at June 30, 2004, were $918 million. During the first quarter of 2004, the Company established an Australian dollar (AUD) 100 million committed credit facility, of which AUD 74 million remained unused at June 30, 2004. The Australian facility expires in 2005. The Company also maintained a Canadian dollar (CAD) 50 million committed credit facility and a CAD 50 million uncommitted credit facility. At June 30, 2004, the Company had not used any portion of this facility. Effective July 1, 2004, the CAD 50 million committed credit facility was cancelled. The uncommitted credit facility expires in 2005. Textron Financial also has a $25 million multi-currency, committed credit facility, of which $20 million remained unused at June 30, 2004. The multi-currency facility expires in September 2004. Textron Financial generally pays fees in support of the committed lines. The Company expects to renew these facilities prior to expiration.

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.

Securitizations are an important source of liquidity for Textron Financial and involve the periodic transfer of finance receivables to qualified special purpose trusts. At both June 30, 2004 and January 3, 2004, the amount of debt related to these securitization trusts was $1.9 billion.

The terms of certain of the Company's loan agreements and credit facilities, under the most restrictive covenant, limit the payment of dividends to $460 million at June 30, 2004. In the first six months of 2004, Textron Financial declared and paid dividends of $72 million.

Note 9. Junior Subordinated Debentures

On June 30, 2004, Textron Financial Corporation redeemed all of the $26 million Litchfield 10% Series A Junior Subordinated Debentures, due 2029. The debentures were held by a trust sponsored and wholly-owned by Litchfield Financial Corporation, a subsidiary of Textron Financial Corporation. The proceeds from the redemption were used to redeem all of the $26 million Litchfield Capital Trust I 10% Series A Trust Preferred Securities at par value of $10 per share. There was no gain or loss on the redemption.

Note 10. Accumulated Other Comprehensive (Loss) Income and Comprehensive Income

Accumulated other comprehensive (loss) income is as follows:

	Six Months Ended	
	June 30, 2004	June 30, 2003
	(In thousands)	
Beginning of period	$ (1,676)	$(14,637)
Amortization of deferred loss on terminated hedge contracts, net of income taxes of $1,107 and $657, respectively	1,845	1,095
Foreign currency translation adjustments	(1,404)	666
Net deferred (loss) gain on hedge contracts, net of income taxes of $(1,313) and $6,043, respectively	(2,439)	10,071
Net deferred (loss) gain on interest-only securities, net of income taxes of $(4,064) and $8,014, respectively	(6,773)	13,357
End of period	$(10,447)	$ 10,552

Comprehensive income is summarized below:

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
	(In thousands)			
Net income	$24,171	$17,049	$45,080	$32,596
Other comprehensive (loss) income	(1,835)	20,334	(8,771)	25,189
Comprehensive income	$22,336	$37,383	$36,309	$57,785

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 subsidiary, 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." In the fourth quarter of 2003, the Company executed 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. While the Company believes it had good defenses to any potential claims by the State of Florida, it has settled the matter with Florida. Such amounts are recorded in selling and administrative expense. 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.

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 in the Consolidated Statements of Income for the year-ended January 3, 2004. The trial judge approved the settlement in July 2004.

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 12. Variable Interest Entities

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. Entities were previously consolidated by an enterprise that had a controlling financial interest through ownership of a majority voting interest in the 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. The Interpretation became effective for entities commonly referred to as special-purpose entities (SPE) in financial statement periods ending after December 15, 2003. The effective date for all other types of entities within the scope of the Interpretation is for financial statement periods ending after March 15, 2004. Textron Financial adopted the revised FIN 46 in the first quarter of 2004. The adoption did not have any impact on its results of operations or financial position.

Note 13. 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, syndicated bank loans and liquidating portfolios related to a strategic realignment of the Company's business and product lines into core and non-core businesses.

Item 1. ***Financial Statements (Continued)***

TEXTRON FINANCIAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited) — (Continued)

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
	(In thousands)			
Revenues:				
Distribution Finance	$ 40,431	$ 38,248	$ 82,647	$ 75,648
Golf Finance	20,946	21,716	37,919	41,304
Resort Finance	19,746	21,270	39,572	40,224
Aircraft Finance	18,546	19,051	37,269	37,802
Asset-Based Lending	13,710	14,937	27,310	29,307
Structured Capital	10,319	8,363	20,528	17,177
Other	13,238	18,947	25,832	41,116
Total revenues	$136,936	$142,532	$271,077	$282,578
Income (loss) from continuing operations before income taxes and distributions on preferred securities: (1) (2)				
Distribution Finance	$ 17,343	$ 15,694	$ 43,400	$ 28,953
Golf Finance	5,273	8,115	7,060	14,164
Resort Finance	1,615	5,230	(5,447)	11,431
Aircraft Finance	5,195	2,471	10,062	973
Asset-Based Lending	4,666	5,141	7,522	8,746
Structured Capital	5,133	3,016	9,720	6,872
Other	(3,470)	(15,579)	(5,585)	(23,612)
Income from continuing operations before income taxes and distributions on preferred securities	$ 35,755	$ 24,088	$ 66,732	$ 47,527

	June 30, 2004	January 3, 2004
	(In thousands)	
Finance assets: (3)		
Resort Finance	$1,325,729	$1,070,352
Aircraft Finance	1,035,475	1,160,029
Golf Finance	1,005,181	886,011
Distribution Finance	872,885	824,618
Structured Capital	632,436	634,308
Asset-Based Lending	521,505	467,759
Other	561,559	747,744
Total finance assets	$5,954,770	$5,790,821

(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

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***

TEXTRON FINANCIAL CORPORATION

Key Business Initiatives and Trends

Portfolio quality improved during the second quarter of 2004. The percentage of accounts greater than 60 days past due decreased slightly to 2.32% from 2.38% and 2.39% at March 31, 2004 and January 3, 2004, respectively, and nonperforming assets decreased $18 million and $14 million, to $148 million, from March 31, 2004 and January 3, 2004, respectively. As a result, the provision for credit losses decreased $12 million and $16 million for the three and six months ended June 30, 2004, as compared to the corresponding periods in 2003. At current levels of delinquency and nonperforming assets, the Company expects stability in these levels for the remainder of 2004; however, the Company could experience an out-of-trend result in any one quarter.

The liquidation of non-core assets in the Other segment continued in the second quarter of 2004. Finance assets in the Other segment decreased $141 million and $186 million, to $562 million, at June 30, 2004 as compared to March 31, 2004 and January 3, 2004, respectively. This decrease was primarily due to portfolio sales of franchise finance receivables and prepayments in the syndicated bank loan and media portfolios.

Advances in portfolio quality were partially offset in the second quarter by weakening of the Company's operating efficiency ratio to 49.6% for the second quarter versus 46.5% in the same period last year, reflecting a $2 million increase in accrued litigation expense related to the reversal of a legal judgment, which had been settled in the Company's favor in a previous year. For the first six months of 2004, operating efficiency improved to 47.1% versus 47.4% in the prior year. The Company continued to recognize the benefits of the restructuring program implemented in the fourth quarter of 2003 and recurring legal and collection expenses stabilized, reflecting the improvements in portfolio quality. However, these improvements were partially offset by increases in employee salaries and benefits.

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 collections and sales of finance receivables and 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.

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 271% and 302% at June 30, 2004 and January 3, 2004, respectively. These lines of credit currently total $1.5 billion, of which $500 million expires in 2005 and $1.0 billion expires in 2008. The $500 million facility includes a one-year term out option, effectively extending its expiration into 2006. In addition, Textron Financial is permitted to borrow under Textron's $1.25 billion revolving credit facilities, of which $250 million expires in 2005 and $1.0 billion expires in 2007. None of these lines of credit were used at June 30, 2004, or January 3, 2004. Lines of credit not reserved as support for outstanding commercial paper or letters of credit were $918 million at June 30, 2004, compared to $966 million at January 3, 2004. The Company maintains a CAD 50 million uncommitted credit facility. This facility expires in September 2004 and was unused at both June 30, 2004 and January 3, 2004. During the first quarter of 2004, Textron Financial established an AUD 100 million committed credit facility, of which AUD 74 million remained unused at June 30, 2004. The Australian facility expires in 2005. Textron Financial also has a $25 million multi-currency committed credit facility, of which

$20 million remained unused at June 30, 2004. This facility also expires in 2005. The Company expects to renew these facilities prior to expiration.

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 $4 billion. Under this registration statement, Textron Financial issued a $45 million term note during the first half of 2004. The proceeds from this issuance were used to refinance maturing debt. At June 30, 2004, Textron Financial had $3.6 billion available under this registration statement.

Cash flows provided by operating activities of continuing operations were $21 million during the first six months of 2004, compared to $121 million in the corresponding period of 2003. The decrease in cash flows was primarily due to the timing of payments of accrued interest and other liabilities, principally as a result of a $60 million income tax payment and settlements of terminated interest rate exchange agreements.

Cash flows (used) provided by investing activities of continuing operations were $(111) million during the first six months of 2004, compared to $106 million in the corresponding period of 2003. The decrease in cash flows largely resulted from a decrease in proceeds from receivable sales, including securitizations. The reduction in proceeds is primarily attributable to the sale of a $95 million franchise portfolio in the first six months of 2003 as well as a $75 million incremental increase in the utilization of the Distribution Finance conduit in 2003 as compared to the corresponding period of 2004.

Cash flows used in financing activities of continuing operations were $180 million during the first six months of 2004, compared to $31 million in the corresponding period of 2003. The increase in cash used by financing activities during the first six months of 2004 compared to the corresponding period in 2003 principally reflects a net reduction of debt outstanding as a result of cash on hand from the sale of discontinued operations at the end of 2003 and an increase in the dividends paid to Textron.

Net cash used in discontinued operations of $173 million during the first half of 2003 represents the operating and investing activities of the small business direct portfolio (small business finance) that was sold in December 2003. The cash used by discontinued operations was funded through the issuance of commercial paper and was not a separate activity of the discontinued operation.

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 82% at June 30, 2004, and 81% at January 3, 2004. Textron Financial's ratio of earnings to fixed charges was 1.90x for the six months ended June 30, 2004, compared to 1.53x for the corresponding period in 2003. Commercial paper and Other short-term debt as a percentage of total debt was 13% at June 30, 2004, compared to 12% at the end of 2003.

During the first six months of 2004, Textron Financial declared and paid dividends to Textron of $71.5 million, compared to dividends declared and paid of $39.5 million during the corresponding period of 2003. The increase in 2004 was due to excess capital that resulted from the continued liquidation of non-core assets and increased profitability. Textron contributed capital of $4.5 million to Textron Financial in the first six months of 2004 and 2003, which consisted of Textron's dividend on the preferred stock held by 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. 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 $248 million in the first half of 2004, compared with $450 million in the first half of 2003. The Company has used the proceeds from these arrangements to fund the origination of new finance receivables and to retire debt. Gains related to these transactions amounted to $29.2 million and $14.9 million during the first half of 2004 and 2003, respectively. Of the $29.2 million of securitization gains in 2004, $24.0 million were related to recurring finance receivable sales into the Distribution Finance revolving securitization conduit, while $2.1 million and $3.1 million were related to incremental finance receivable sales into the Distribution Finance and Aircraft Finance securitization conduits, respectively. Cash collections on current and prior period securitization gains were $32.5 million and $21.1 million for the first six months of 2004 and 2003, respectively.

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 in 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 at June 30, 2004, and January 3, 2004 are presented in the following table.

	June 30, 2004		January 3, 2004		Increase/ (Decrease)
	(Dollars in thousands)				
Distribution Finance	$2,179,843	26%	$1,987,299	24%	$ 192,544
Aircraft Finance	1,742,164	21%	1,914,147	23%	(171,983)
Resort Finance	1,352,701	16%	1,134,951	14%	217,750
Golf Finance	1,331,580	16%	1,293,917	16%	37,663
Structured Capital	632,436	8%	634,308	8%	(1,872)
Asset-Based Lending	521,505	6%	467,759	6%	53,746
Other	557,645	7%	747,744	9%	(190,099)
Total managed finance assets	$8,317,874	100%	$8,180,125	100%	$ 137,749

Managed finance assets within the core businesses increased $328 million, primarily as a result of growth in the Resort Finance and private brands portfolio within Distribution Finance. This increase was partially offset by higher collections, net of new finance receivable originations, and payoff of a large customer in Aircraft Finance. The growth in the Resort Finance portfolio reflects stronger originations and a $132 million portfolio purchase. The decrease in the Other segment represents the continued portfolio collections, prepayments and sales of the liquidating portfolios.

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 collection is doubtful. 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 June 30, 2004 and January 3, 2004 by business segment.

	June 30, 2004		January 3, 2004	
	(Dollars in thousands)			
Resort Finance	$ 66,319	5.00%	$ 55,118	5.15%
Golf Finance	16,716	1.66%	21,507	2.43%
Aircraft Finance	12,452	1.20%	25,628	2.21%
Distribution Finance	6,832	0.78%	11,117	1.35%
Asset-Based Lending	6,140	1.18%	5,844	1.25%
Other	39,355	7.01%	42,775	5.72%
Total nonperforming assets	$147,814	2.48%	$161,989	2.80%

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. Nonperforming assets decreased $14.2 million at June 30, 2004, as compared to January 3, 2004 and, at current levels, the Company expects the balances to remain relatively stable. The increase in Resort Finance primarily reflects an increase in the land finance portfolio. Management believes that the nonperforming asset level within land finance is at, or near, its peak.

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 June 30, 2004, floating rate liabilities in excess of floating rate assets were $312 million, net of $2.2 billion of interest rate exchange agreements on fixed rate long-term debt and $222 million of interest rate exchange agreements on fixed rate finance receivables. Classified within fixed rate assets are approximately $952 million of floating rate loans with index rate floors that are, on average, 123 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. In addition, $775 million of floating rate receivables with index rate floors have been sold into the Distribution Finance securitization conduit. Since this conduit issues floating rate liabilities to investors, Textron Financial currently benefits, in connection with the Company's ownership of the conduit's residual interest, from the interest differential between the floor rates and the index rates. On average, these receivables have index rate floors that are 171 basis points above the applicable index rate.

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 finance 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 June 30, 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 $4.1 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.

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 were $2.9 million at June 30, 2004.

Results of Operations

For the three and six months ended June 30, 2004 vs. June 30, 2003

Revenues and Net Interest Margin

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

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
	(Dollars in thousands)			
Finance charges and discounts	$ 85,105	$104,637	$179,156	$208,396
Rental revenues on operating leases	7,031	6,306	13,574	14,019
Other income	44,800	31,589	78,347	60,163
Total revenues	136,936	142,532	271,077	282,578
Interest expense	34,092	45,072	72,556	88,775
Depreciation of equipment on operating leases	4,450	3,758	8,632	8,295
Net interest margin	$ 98,394	$ 93,702	$189,889	$185,508
Portfolio yield	7.04%	7.49%	7.42%	7.64%
Net interest margin as a percentage of average net investment	7.80%	6.45%	7.54%	6.52%

The decrease in finance charges principally reflects lower average finance receivables of $712 million and $602 million for the three and six months ended June 30, 2004, respectively, and a lower interest rate environment. The increase in other income was mostly due to higher securitization gains in Distribution Finance ($8.1 million and $14.5 million), increased syndication gains ($2.8 million and $3.0 million) and increased prepayment income ($1.9 million and $1.8 million) for the three and six months ended June 30, 2004, respectively. The increase in Distribution Finance securitization gains was due to a $355 million and $330 million average increase in finance receivables sold for the three and six months ended June 30, 2004, respectively and improved pricing on the revolving conduit. Cash collected on the Company's retained interest in the conduit also increased $8.5 million and $11.8 million for the three and six months ended June 30, 2004,

respectively. Interest expense decreased 24% and 18% for three and six months ended June 30, 2004, respectively, compared to the corresponding periods in 2003, which exceeds the comparable decreases in finance charges of 19% and 14%. This decrease reflects relatively lower money cost due to the maturity of higher rate debt.

Selling and Administrative Expenses

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
	(Dollars in thousands)			
Selling and administrative expenses as a percentage of managed and serviced receivables	2.27%	1.88%	2.08%	1.92%
Operating efficiency ratio	49.6%	46.5%	47.1%	47.4%
Selling and administrative expenses	$48,804	$43,580	$89,520	$87,945

The increase in selling and administrative expense reflects increases in employee salaries and benefits ($2.8 million and $1.8 million) and increased depreciation expense ($1.0 million and $1.8 million) for the three and six months ended June 30, 2004, respectively. Legal and collection expense increased $2.8 million for the three months ended June 30, 2004 and decreased $2.5 million for the six months ended June 30, 2004. The increase for the second quarter was primarily due to the reversal of a $2.0 million legal judgment, which had been settled in the Company's favor in a previous period. This judgment offsets the overall decrease in legal and collection expenses for the first six months of 2004 resulting from improved portfolio quality. The increase in employee salaries and benefits principally reflects higher health care costs and increased performance based compensation tied to the Company's improved profitability.

Provision for Losses

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
	(In thousands)			
Allowance for losses on receivables beginning of period	$119,599	$146,374	$119,148	$144,885
Provision for losses	13,835	26,034	33,637	50,036
Less net charge-offs:				
Resort Finance	14,829	2,329	21,177	3,201
Distribution Finance	3,652	3,599	6,869	8,046
Aircraft Finance	2,772	5,875	3,035	10,390
Asset-Based Lending	864	271	516	5,755
Golf Finance	491	1,092	504	1,960
Structured Capital	—	—	—	—
Other	1,661	17,376	11,516	23,703
Total net charge-offs	24,267	30,542	43,618	53,055
Acquisitions and Other	1,950	—	1,950	—
Allowance for losses on receivables end of period	$111,117	$141,866	$111,117	$141,866

The decrease in the provision largely reflects an improvement in portfolio quality. Nonperforming assets decreased $58.5 million to $147.8 million at June 30, 2004 from $206.3 million at June 30, 2003. The decrease in net charge-offs was primarily attributable to Aircraft Finance and Other, partially offset by an increase in

Resort Finance. The decrease in Aircraft Finance reflects an improvement in general economic conditions and aircraft values, and the decrease in Other reflects the Company's reduced level of exposure to non-core assets. The increase in Resort Finance primarily relates to the charge-off of two accounts for which reserves had been previously provided.

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 income taxes and distributions on preferred securities.

Distribution Finance

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
	(In thousands)			
Revenues	$40,431	$38,248	$82,647	$75,648
Net interest margin	$37,098	$32,875	$75,395	$64,920
Selling and administrative expenses	16,187	13,367	30,126	25,379
Provision for losses	3,568	3,814	1,869	10,588
Segment income	$17,343	$15,694	$43,400	$28,953

The increase in Distribution Finance segment income reflected lower provision for losses and a higher net interest margin, partially offset by higher selling and administrative expenses. The increase in net interest margin for the three and six months ended June 30, 2004 was primarily due to an increase in other income from increased revolving conduit securitization activity ($8.1 million and $14.5 million). The decrease in provision for losses represents a change in reserving requirements for this segment based on strong portfolio performance as supported by improvements in 12- and 36-month loss to liquidation ratios.

Resort Finance

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
	(In thousands)			
Revenues	$19,746	$21,270	$39,572	$40,224
Net interest margin	$13,709	$14,003	$27,380	$26,805
Selling and administrative expenses	6,213	5,832	12,339	11,077
Provision for losses	5,881	2,941	20,488	4,297
Segment income	$ 1,615	$ 5,230	$(5,447)	$11,431

Resort Finance segment income decreased, reflecting a higher provision for losses. The increase in provision for losses for both the three- and six-month periods is primarily due to an increase in nonperforming asset levels in the land finance portfolio, specific reserving actions taken on several nonperforming accounts and an increase in finance receivables.

Aircraft Finance

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
	(In thousands)			
Revenues	$18,546	$19,051	$37,269	$37,802
Net interest margin	$ 9,260	$ 7,015	$17,744	$12,682
Selling and administrative expenses	3,295	4,143	6,912	8,458
Provision for losses	770	401	770	3,251
Segment income	$ 5,195	$ 2,471	$10,062	$ 973

The improvement in Aircraft Finance segment income was primarily due to an increase in net interest margin and reduced selling and administrative expenses for both the three and six months ended June 30, 2004, and a decrease in the provision for losses for the six months ended June 30, 2004. The increase in net interest margin reflected an increase in other income, primarily as a result of increased securitization gains ($1.7 million) for the six months ended June 30, 2004, as well as improvement in receivable yields for both the three and six months ended June 30, 2004. The reduction in selling and administrative expenses reflects lower legal and collection expenses as a result of improved credit quality. Improvements in credit quality, evidenced by a $13.2 million decrease in nonperforming asset levels from January 3, 2004, also contributed to the reduction in provision for losses.

Golf Finance

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
	(In thousands)			
Revenues	$20,946	$21,716	$37,919	$41,304
Net interest margin	$11,971	$13,337	$19,812	$24,173
Selling and administrative expenses	5,202	4,486	9,608	8,719
Provision for losses	1,496	736	3,144	1,290
Segment income	$ 5,273	$ 8,115	$ 7,060	$14,164

Golf Finance segment income decreased primarily as a result of lower net interest margin and higher provision for losses. The decrease in net interest margin was mostly due to lower other income ($0.6 million and $2.5 million), lower pricing and increased interest expense as a result of higher debt levels from a reduction in deferred income tax liabilities. The decrease in other income resulted from lower earnings on retained securitization interests due to the voluntary liquidation and termination of a golf equipment securitization conduit in the fourth quarter of 2003, and to a one-time advisory fee of $1.5 million that was earned in the first quarter of 2003. Decreases in securitization gains due to the voluntary liquidation and termination of a golf equipment securitization conduit in 2003 were offset by an increase in syndication income related to golf course mortgages. The increase in provision for losses reflects higher reserving requirements related to nonperforming assets.

Asset-Based Lending

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
	(In thousands)			
Revenues	$13,710	$14,937	$27,310	$29,307
Net interest margin	$11,357	$12,113	$22,371	$23,499
Selling and administrative expenses	5,857	6,722	11,116	13,240
Provision for losses	834	250	3,733	1,513
Segment income	$ 4,666	$ 5,141	$ 7,522	$ 8,746

Asset-Based Lending segment income decreased slightly due to a higher provision for losses as a result of a slight increase in nonperforming assets, and a $54 million increase in finance receivables as compared to January 3, 2004, partially offset by lower selling and administrative expenses primarily as a result of the restructuring program implemented during the fourth quarter of 2003.

Structured Capital

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
	(In thousands)			
Revenues	$10,319	$8,363	$20,528	$17,177
Net interest margin	$ 6,177	$3,704	$11,506	$ 8,316
Selling and administrative expenses	1,044	688	1,786	1,444
Provision for losses	—	—	—	—
Segment income	$ 5,133	$3,016	$ 9,720	$ 6,872

Structured Capital segment income increased as a result of higher net interest margin, primarily due to higher average finance receivables ($48 million and $51 million) for the three and six months ended June 30, 2004.

Other Segment

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
	(In thousands)			
Revenues	$13,238	$ 18,947	$25,832	$ 41,116
Net interest margin	$ 8,822	$ 10,655	$15,681	$ 25,113
Selling and administrative expenses	11,006	8,342	17,633	19,625
Provision for losses	1,286	17,892	3,633	29,100
Segment income	$(3,470)	$(15,579)	$(5,585)	$(23,612)

Other segment loss decreased, reflecting a significantly lower provision for losses and lower selling and administrative expenses, partially offset by a lower net interest margin. The decrease in the provision for losses reflects a declining level of nonperforming assets and delinquencies within the media, franchise and syndicated bank loan portfolios, and a decrease in finance receivables of $192 million from January 3, 2004, which resulted in lower provisioning requirements. The lower selling and administrative expenses for the six months ended June 30, 2004, and lower net interest margin for both the three and six months ended June 30, 2004 largely reflect the continued liquidation of the finance receivables within these non-core businesses through

portfolio sales, prepayments and collections, partially offset by an increase in prepayment income, primarily related to the media finance portfolio ($2.1 million), in the second quarter of 2004. Average finance receivables declined $412.3 million and $442.3 million in 2004, as compared to the corresponding three and six month periods in 2003. The increased selling and administrative expenses for the three months ended June 30, 2004 was primarily the result of the reversal of a $2.0 million legal judgment, which had been settled in the Company's favor in a previous period.

Income From Continuing Operations

Three months ended June 30, 2004 vs. June 30, 2003

Income from continuing operations of $24.2 million for the second quarter of 2004 was $8.6 million, or 56%, higher than the corresponding period of 2003. The increase was primarily due to a $12.2 million reduction in provision for losses as a result of improving portfolio quality and a $4.7 million increase in net interest margin as a result of other income from securitizations, syndications and prepayment penalties, partially offset by a $5.2 million increase in selling and administrative expenses, primarily due to increases in employee salaries and benefits costs and an increase in litigation related expense.

Six months ended June 30, 2004 vs. June 30, 2003

Income from continuing operations of $45.1 million for the six months ended 2004 was $14.3 million, or 46%, higher than the corresponding period of 2003. The increase was primarily due to a $16.4 million reduction in provision for losses as a result of improving portfolio quality and a $4.4 million increase in net interest margin as a result of other income from securitizations, syndications, and prepayment penalties, partially offset by a $1.6 million increase in selling and administrative expenses, primarily due to increases in employee salaries and benefits costs, offset by lower legal and collection expense.

Selected Financial Ratios

	Three Months Ended		Six Months Ended	
	June 30, 2004	June 30, 2003	June 30, 2004	June 30, 2003
Net interest margin as a percentage of average net investment(1)	7.80%	6.45%	7.54%	6.52%
Return on average equity	9.93%	6.68%	9.15%	6.44%
Return on average assets	1.58%	0.94%	1.48%	0.98%
Ratio of earnings to fixed charges	2.03x	1.53x	1.90x	1.53x
Selling and administrative expenses as a percentage of average managed and serviced finance receivables(2)	2.27%	1.88%	2.08%	1.92%
Operating efficiency ratio(3)	49.6%	46.5%	47.1%	47.4%
Net charge-offs as a percentage of average finance receivables	1.88%	2.07%	1.69%	1.84%

	June 30, 2004	January 3, 2004
60+ days contractual delinquency as a percentage of finance receivables(4)	2.32%	2.39%
Nonperforming assets as a percentage of finance assets(5)	2.48%	2.80%
Allowance for losses on receivables as a percentage of finance receivables	2.1%	2.3%
Allowance for losses as a percentage of nonaccrual finance receivables	78.5%	78.4%
Total debt to tangible shareholder's equity(6)	5.28x	5.24x

(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) Average managed and serviced finance receivables include owned finance receivables, finance receivables serviced under securitizations, participations and third-party portfolio servicing agreements.

(3) Operating efficiency ratio is selling and administrative expenses divided by net interest margin.

(4) Delinquency excludes captive finance receivables with recourse to Textron. Captive finance 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 finance receivables.

(5) 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.

(6) Tangible shareholder's equity equals Shareholder's equity, excluding Accumulated other comprehensive income or loss, less Goodwill.

Forward-looking Information

Certain statements in this quarterly report on 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 speak only as of the date on which they were made, and we undertake no obligation to update or revise any forward-looking statements. 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 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 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*

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

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 issue 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, 2004.

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 9, 2004

TEXTRON FINANCIAL CORPORATION

/s/ THOMAS J. CULLEN

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