

# Notes to Consolidated Financial Statements

## 1. Summary of Significant Accounting Policies

### Nature of Operations and Principles of Consolidation

Textron is a global, multi-industry company with manufacturing and finance operations. Its principal markets (listed within segments in order of the amount of 2001 revenues) and the major locations of such markets are as follows:

Segment	Principal Markets	Major Locations
<b>Aircraft</b>	<ul style="list-style-type: none"> <li>• Business jets</li> <li>• Commercial and military helicopters</li> <li>• General aviation</li> <li>• Overnight express package carriers</li> <li>• Commuter airlines, relief flights, tourism and freight</li> </ul>	<ul style="list-style-type: none"> <li>• North America</li> <li>• Western Europe</li> <li>• South America</li> <li>• Asia and Australia</li> </ul>
<b>Automotive</b>	<ul style="list-style-type: none"> <li>• Automotive original equipment manufacturers and their suppliers</li> </ul>	<ul style="list-style-type: none"> <li>• North America</li> <li>• Western Europe</li> <li>• South America</li> </ul>
<b>Fastening Systems</b>	<ul style="list-style-type: none"> <li>• Automotive</li> <li>• Industrial</li> <li>• Non-Auto Transportation</li> <li>• Aerospace</li> <li>• Electronics</li> <li>• Construction</li> </ul>	<ul style="list-style-type: none"> <li>• North America</li> <li>• Western Europe</li> <li>• Asia and Australia</li> <li>• South America</li> </ul>
<b>Industrial Products</b>	<ul style="list-style-type: none"> <li>• Industrial components: commercial aerospace and defense</li> <li>• Golf and turf-care products: golf courses, resort communities, and commercial and industrial users</li> <li>• Fluid and power systems: original equipment manufacturers, distributors and end-users of a wide variety of products</li> <li>• Light construction equipment: commercial customers, national rental fleets and the U.S. Government</li> </ul>	<ul style="list-style-type: none"> <li>• North America</li> <li>• Western Europe</li> <li>• Asia and Australia</li> </ul>
<b>Finance</b>	<ul style="list-style-type: none"> <li>• Commercial loans and leases</li> </ul>	<ul style="list-style-type: none"> <li>• North America</li> </ul>

The consolidated financial statements include the accounts of Textron and all of its majority- and wholly owned subsidiaries. Investments in which Textron does not have control, but has the ability to exercise significant influence over the operating and financial policies, are accounted for under the equity method. Textron's share of net earnings and losses from these investments is included in the consolidated statement of income.

Textron's financings are conducted through two borrowing groups, Textron Finance and Textron Manufacturing. This framework is designed to enhance Textron's borrowing power by separating the Finance segment. Textron Finance consists of Textron Financial Corporation consolidated with its subsidiaries, which are the entities through which Textron operates its Finance segment. Textron Finance finances its operations by borrowing from its own group of external creditors. Certain intercompany transactions between borrowing groups have not been eliminated in the consolidated financial statements. See "Due to Textron Manufacturing" in Note 7 for further details. All other significant intercompany transactions are eliminated.

Textron Manufacturing is Textron Inc., the parent company, consolidated with the entities which operated in the Aircraft, Automotive, Fastening Systems and Industrial Products business segments during 2001. In 2001, management responsibility for a division previously reported in the Fastening Systems segment was transferred to the Industrial Products segment. Prior period data shown in the financial statements and related notes have been reclassified, as appropriate.

The preparation of these financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect these statements and accompanying notes. Some of the more significant estimates include inventory valuation, residual values of leased assets, allowance for credit losses on receivables, product liability, workers compensation, actuarial assumptions for the pension and postretirement plans, estimates of future cash flows associated with long-lived assets, environmental and warranty reserves and amounts reported under long-term contracts. Management's estimates are based on the facts and circumstances available at the time estimates are

made, historical experience, risk of loss, general economic conditions and trends, and management's assessments of the probable future outcome of these matters. Actual results could differ from such estimates.

### **Cash and Cash Equivalents**

Cash and cash equivalents consist of cash and short-term, highly liquid securities with original maturities of ninety days or less.

### **Revenue Recognition**

Revenue is generally recognized when products are delivered or services are performed. With respect to aircraft, delivery is upon completion of manufacturing, customer acceptance and the transfer of risk and rewards of ownership.

Revenue under fixed-price contracts are generally recorded as deliveries are made. Certain long-term fixed-price contracts provide for periodic delivery after a lengthy period of time over which significant costs are incurred or require a significant amount of development effort in relation to total contract volume. Revenues under those contracts and all cost-reimbursement-type contracts are recorded as costs are incurred. Revenues under the V-22 low-rate initial production contract with the U.S. Government are recorded as costs are incurred. Certain contracts are awarded with fixed-price incentive fees. Incentive fees are considered when estimating revenues and profit rates, and are recorded when these amounts are reasonably determined. Long-term contract profits are based on estimates of total sales value and costs at completion. Such estimates are reviewed and revised periodically throughout the contract life. Revisions to contract profits are recorded when the revisions to estimated sales value or costs are made. Estimated contract losses are recorded when identified.

Revenue from certain qualifying non-cancelable aircraft and other product lease contracts are accounted for as sales-type leases. The present value of all payments, net of executory costs, is recorded as revenue, and the related costs of the product are charged to cost of sales. Generally, this lease financing is through Textron Finance and the associated interest is recorded over the term of the lease agreement using the interest method. Lease financing transactions which do not qualify as sales-type leases are accounted for under the operating method wherein revenue is recorded as earned over the lease period.

Finance revenues include interest on finance receivables which is recognized in revenues using the interest method to provide a constant rate of return over the terms of the receivables. Finance revenues also include direct loan origination costs and fees received which are deferred and amortized over the contractual lives of the respective receivables using the interest method. Accrual of interest income is suspended for accounts which 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. Accrual of interest is resumed when the loan becomes contractually current, and suspended interest income is recognized at that time.

### **Allowance for Losses on Finance Receivables**

Provisions for losses on finance receivables are charged to income in amounts sufficient to maintain the allowance at a level considered adequate to cover losses in the existing receivable portfolio. Management evaluates the allowance by examining current delinquencies, the characteristics of the existing accounts, historical loss experience, the value of the underlying collateral and general economic conditions and trends.

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

### **Receivable Securitizations**

Textron Finance sells or securitizes loans and leases and retains servicing responsibilities and subordinated interests, including interest-only securities, subordinated certificates and cash reserves, all of which are retained interests in the securitized receivables. These retained interests are subordinate to investors' interest. Gains or losses on sale of the finance receivables depend in part on the previous carrying amount of the finance receivables involved in the transfer, allocated between assets sold and retained interests based on their relative fair values at the date of transfer. Textron Finance estimates fair value based on the present value of future expected cash flows using management's best estimates of the key assumptions – credit losses, prepayment speeds, forward interest rate yield curves, and discount rates commensurate with the risks involved. Textron Finance reviews the fair value of the retained interests quarterly using

updated assumptions and compares such amounts with the carrying value of the retained interests. When the carrying value exceeds the fair value of the retained interests and the decline is determined to be other than temporary, the retained interest is written down to fair value.

### **Investment Securities**

Investments in marketable securities and retained interests from securitizations are classified as available-for-sale and are recorded at their fair value as a component of other assets. Unrealized gains and losses on these securities, net of income taxes, are included in shareholders' equity as a component of accumulated other comprehensive loss (OCL). If a decline in the fair value of a marketable security is judged to be other than temporary, the cost basis is written down to fair value with a charge to earnings. Non-marketable equity securities are accounted for under either the cost or equity method of accounting.

### **Inventories**

Inventories are carried at the lower of cost or market. The cost of approximately 60% of inventories is determined using the last-in, first-out method. The cost of remaining inventories, other than those related to certain long-term contracts, are generally valued by the first-in, first-out method. Costs for commercial helicopters are determined on an average cost basis by model considering the expended and estimated costs for the current production release.

### **Property, Plant and Equipment**

Property, plant and equipment are recorded at cost and are depreciated primarily using the straight-line method. Land improvements and buildings are depreciated primarily over estimated lives ranging from 12 to 40 years, while machinery and equipment are depreciated primarily over 3 to 10 years. Expenditures for improvements that increase asset values and extend useful lives are capitalized. Expenditures for maintenance and repairs are expensed as incurred.

### **Intangible Assets**

Intangible assets are primarily comprised of goodwill which is amortized using the straight-line method over the estimated period of benefit, ranging from 10 to 40 years. Accumulated amortization of goodwill totaled \$654 million and \$564 million in 2001 and 2000, respectively. Textron periodically evaluates the recoverability of intangible assets whenever events or changes in circumstances, such as declines in sales, earnings or cash flows or material adverse changes in the business climate indicate that the carrying amount of an asset may not be recoverable.

### **Derivative Financial Instruments**

As of December 31, 2000, Textron adopted Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, which requires that all derivative instruments be reported on the balance sheet at fair value and establishes criteria for designation and effectiveness of hedging relationships. Changes in the fair value of derivative financial instruments are either recognized periodically in income or in shareholders' equity as a component of comprehensive income (loss) depending on whether the derivative financial instrument qualifies for hedge accounting, and if so, whether it qualifies as a fair value hedge or cash flow hedge. In accordance with SFAS No. 133, Textron recorded a cumulative transition adjustment to increase accumulated OCL by approximately \$15 million, net of income taxes, to recognize the fair value of cash flow hedges as of the date of adoption. The cumulative effect of adoption was not material to the consolidated statement of income.

Textron is exposed to market risk, primarily from changes in interest rates, currency exchange rates and securities pricing. To manage the volatility relating to these exposures, Textron nets the exposures on a consolidated basis to take advantage of natural offsets. For the residual portion, Textron enters into various derivative transactions pursuant to Textron's policies in such areas as counterparty exposure and hedging practices. Designation is performed on a specific exposure basis to support hedge accounting. Changes in fair value of financial instruments qualifying as fair value hedges are recorded in income, offset in part or in whole by corresponding changes in the fair value of the underlying exposures being hedged. Changes in fair values of derivatives accounted for as cash flow hedges, to the extent they are effective as hedges, are recorded in OCL net of deferred taxes. Textron has not incurred or recognized any gains or losses in earnings as the result of the ineffectiveness of or the exclusion from its assessment of hedge effectiveness of its fair value or cash flow hedges. Changes in fair value of derivatives not qualifying as hedges are reported in income. Textron does not hold or issue derivative financial instruments for trading or speculative purposes.

Prior to the adoption of SFAS No. 133, interest rate swaps were accounted for on the accrual basis with the differential to be paid or received recorded currently as an adjustment to interest expense. Premiums

paid to terminate agreements designated as hedges were deferred and amortized to expense over the remaining term of the original life of the contract. If the underlying debt was then paid early, unamortized premiums were recognized as an adjustment to the gain or loss associated with the debt's extinguishment. For foreign currency forward contracts hedging firm sales and purchase commitments, gains and losses were included in the measurement of the underlying transactions when they occurred. Gains and losses from currency rate changes on hedges of foreign currency transactions were recorded currently in income.

Foreign currency denominated assets and liabilities are translated into U.S. dollars with the adjustments from the currency rate changes being recorded in the cumulative translation adjustment account in shareholders' equity until the related foreign entity is sold or substantially liquidated. Foreign currency financing transactions, including currency swaps, are used to effectively hedge long-term investments in foreign operations with the same corresponding currency. Foreign currency gains and losses on the hedge of the long-term investments are recorded in the cumulative translation adjustment account in accumulated OCL with the offset recorded as an adjustment to the non-U.S. dollar financing liability.

#### **Fair Values of Financial Instruments**

Fair values of cash and cash equivalents, accounts receivable, accounts payable and variable-rate receivables and debt approximate cost. The estimated fair values of other financial instruments, including debt, equity and risk management instruments, have been determined using available market information and valuation methodologies, primarily discounted cash flow analysis or independent investment bankers. The estimated fair value of nonperforming loans included in finance receivables are based on discounted cash flow analyses using risk-adjusted interest rates or the fair value of the related collateral. Because considerable judgment is required in interpreting market data, the estimates are not necessarily indicative of the amounts that could be realized in a current market

#### **Stock-Based Compensation**

Stock-based compensation awards to employees are accounted for using the intrinsic value method prescribed in APB 25, "Accounting for Stock Issued to Employees" and related interpretations.

#### **Product and Environmental Liabilities**

Product liability claims are accrued on the occurrence method based on insurance coverage and deductibles in effect at the date of the incident and management's assessment of the probability of loss when reasonably estimable.

Environmental liabilities are recorded based on the most probable cost, if known, or on the estimated minimum cost, determined on a site-by-site basis. Textron's environmental liabilities are undiscounted and do not take into consideration possible future insurance proceeds or significant amounts from claims against other third parties.

#### **New Accounting Pronouncements**

In June 2001, the Financial Accounting Standards Board (FASB) issued Statements of Financial Accounting Standards (SFAS) No. 141, "Business Combinations," and No. 142, "Goodwill and Other Intangible Assets," effective for fiscal years beginning after December 15, 2001. Under the new rules, goodwill, along with intangible assets deemed to have indefinite lives, will no longer be amortized but will be subject to annual impairment tests in accordance with the Statements. Also, business combinations initiated after June 30, 2001 must be accounted for using the purchase method of accounting.

Textron will apply the new rules on accounting for goodwill and other intangible assets beginning in the first quarter of 2002. Application of the nonamortization provisions of the Statement, excluding Automotive Trim, would have resulted in an increase in net income of \$81 million. During 2002, Textron will perform the first of the required impairment tests of goodwill and indefinite lived intangible assets as of December 30, 2001 and has not yet determined what the effect of these tests will be on Textron's results of operations and financial position.

In August 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 requires that one accounting model be used for long-lived assets to be disposed of by sale. Discontinued operations will be measured similar to other long-lived assets classified as held for sale at the lower of its carrying amount or fair value less cost to sell. Future operating losses will no longer be recognized before they occur. SFAS No. 144 also broadens the presentation of discontinued operations to include a component of an entity when operations and cash flows can be clearly distinguished. The provisions of this Statement are effective for financial statements issued for fiscal years beginning after December 15, 2001. At this time, the adoption of this Statement is not expected to have a material effect on Textron's results of operations or financial position.

## 2. Acquisitions and Dispositions

### Acquisitions

During 2001, Textron Manufacturing acquired four companies at a total cost of \$209 million. Textron Manufacturing also made a \$40 million capital contribution to Textron Finance in support of its acquisition of a \$387 million loan portfolio. The largest of Textron Manufacturing's acquisitions was Tempo Research Corporation which expanded Textron's growing presence in the data-signal-voice test and installation equipment market in the Industrial Products segment.

During 2000, Textron Manufacturing acquired 11 companies and the minority interests of two entities and entered into one joint venture at a total cost of \$121 million, including debt assumed of \$36 million. One of the larger acquisitions was Advantage Molding and Decorating – a leading supplier of injection molded parts, tooling and pad-printed designs.

During 1999, Textron Manufacturing acquired 14 companies and entered into two joint ventures. The largest of these acquisitions were Flexalloy Inc. – a provider of vendor-managed inventory services for the North American fastener markets; OmniQuip International, Inc. – a manufacturer of light construction equipment, and InteSys Technologies Inc. – a provider of plastics and metal engineered assemblies. The total cost of the acquisitions and investments in joint ventures was approximately \$1.2 billion, including treasury stock issued for \$32 million and debt assumed of \$308 million. In addition, Textron Finance had acquisitions totaling \$1.3 billion, including debt assumed of \$547 million. The largest of these acquisitions were Litchfield Financial Corporation, a commercial finance company specializing in the vacation ownership timeshare industry and the aircraft and franchise finance divisions of GreenTree Financial Servicing Corporation. Capital contributions made by Textron Manufacturing to Textron Finance in support of these acquisitions were \$337 million.

The purchase method of accounting has been used for all acquisitions during the past three years.

### Dispositions

On December 20, 2001, Textron completed the sale of its Automotive Trim business to Collins & Aikman Products Company, a subsidiary of Collins & Aikman Corporation, for \$668 million in cash, non-marketable preferred shares of Collins & Aikman valued at \$147 million, 18 million shares of Collins & Aikman common stock valued at \$90 million and a transfer of \$60 million in indebtedness. In addition, Textron Automotive Trim entered into an \$87 million lease agreement whereby equipment used by the Automotive Trim business was retained by Textron and leased back to the business through Textron Financial Corporation. Textron also retained a 50% interest in the Italian operating company, which Textron will have the right to sell to Collins & Aikman for \$23 million at a future date. Textron recognized a \$339 million gain on the sale, and received after-tax proceeds of approximately \$582 million, including the transfer of indebtedness. Textron intends to repurchase shares and reduce debt with these proceeds. The agreement also includes a provision that entitles Textron to an additional cash payment of up to \$125 million to be calculated based on Collins & Aikman's operating results for the five-year period ending 2006.

In January 1999, Textron completed the sale of Avco Financial Services (AFS) to Associates First Capital Corporation for \$3.9 billion in cash. Net after-tax proceeds were approximately \$2.9 billion, resulting in an after-tax gain of \$1.65 billion.

## 3. Finance Receivables and Securitizations

### Finance Receivables

Textron Finance provides financial services primarily to the aircraft, golf, vacation interval resort, dealer floorplan and middle market industries under a variety of financing vehicles with various contractual maturities.

Installment contracts and finance leases have initial terms ranging from one to 15 years, and are generally secured by the financed equipment. Floorplan and revolving receivables generally mature within one to three years. Floorplan receivables are generally secured by the inventory at the financed distributor, while revolving loans are secured by trade receivables, inventory, plant and equipment, and pools of vacation interval notes receivables and the underlying real property. Golf course mortgages have initial terms ranging from three to seven years with amortization periods from 15 to 25 years. Resort mortgages generally represent construction and inventory loans with terms up to 24 months. Golf course and resort mortgages are secured by real property and are generally limited to 75% or less of the property's appraised market value at loan origination. Leveraged leases are secured by the ownership of the leased equipment or real property and have initial terms up to 30 years.

At the end of 2001 and 2000, Textron Finance had nonaccrual finance receivables, excluding receivables with recourse to the Manufacturing group, totaling \$114 million and \$102 million, respectively. Approximately \$54 million and \$76 million of these respective amounts were considered impaired, which excludes finance leases and homogeneous loan portfolios. The allowance for losses on finance receivables related to impaired loans was \$11 million and \$34 million at the end of 2001 and 2000, respectively. The average recorded investment in impaired loans during 2001 and 2000 was \$51 million and \$76 million, respectively.

The following table displays the contractual maturity of the finance receivables. It does not necessarily reflect future cash collections because of various factors including the repayment or refinancing of receivables prior to maturity. Cash collections from finance receivables, excluding finance charges and proceeds from receivable sales or securitizations, were \$5.8 billion and \$5.2 billion in 2001 and 2000, respectively. In the same periods, the ratio of cash collections (net of finance charges) to average net receivables, excluding floorplan receivables and revolving loans, was approximately 65% and 59%, respectively.

<i>(In millions)</i>	Contractual Maturities					Finance Receivables Outstanding	
	2002	2003	2004	2005	Thereafter	2001	2000
Installment contracts	\$ 359	\$ 210	\$ 181	\$ 174	\$ 1,123	\$ 2,047	\$ 1,985
Floorplan receivables	327	92	3	11	41	474	894
Revolving loans	691	249	90	266	283	1,579	1,305
Finance leases	42	37	44	126	70	319	361
Golf course and resort mortgages	102	95	101	121	394	813	683
Leveraged leases	(16)	(14)	27	18	389	404	361
	\$ 1,505	\$ 669	\$ 446	\$ 716	\$ 2,300	\$ 5,636	\$ 5,589
Less allowance for credit losses						144	116
						\$ 5,492	\$ 5,473

The net investment in finance leases and leveraged leases were as follows:

<i>(In millions)</i>	2001	2000
Finance and leveraged lease receivables	\$ 490	\$ 508
Estimated residual values on leased assets	589	589
	1,079	1,097
Unearned income	(356)	(375)
Investment in leases	723	722
Deferred income taxes	(258)	(265)
Net investment in leases	\$ 465	\$ 457

The activity in the allowance for credit losses on finance receivables is as follows:

<i>(In millions)</i>	2001	2000	1999
Balance at the beginning of the year	\$ 116	\$ 113	\$ 84
Provision for losses	82	37	32
Charge-offs	(82)	(45)	(28)
Recoveries	8	7	5
Acquisitions and other	20	4	20
Balance at the end of the year	\$ 144	\$ 116	\$ 113

At year-end 2001, Textron Finance had unused commitments to fund new and existing customers under \$1.3 billion and \$599 million of committed and uncommitted, respectively, revolving lines of credit. Generally, interest rates on these commitments are not set until the loans are funded; therefore, Textron Finance is not exposed to interest rate changes.

Textron Finance manages finance receivables for a variety of investors, participants and third-party portfolio owners. The total managed finance receivable portfolio, including owned finance receivables, was \$9.3 billion at year-end 2001, and \$8.0 billion at year-end 2000.

Owned and securitized finance receivables are primarily diversified geographically across the United States, along with 12% held internationally. At December 29, 2001, Textron Finance's most significant collateral concentration was aircraft, which accounted for 23% of owned and securitized receivables. Textron Finance has industry concentrations in the golf and vacation interval industries, which accounted for 17% and 11%, respectively.

### Transactions Between Finance and Manufacturing Groups

A portion of Textron Finance's business involves financing retail purchases and leases for new and used aircraft and equipment manufactured by Textron Manufacturing's Aircraft and Industrial Products segments. In 2001, 2000 and 1999, Textron Finance paid Textron Manufacturing \$1.3 billion, \$1.4 billion, and \$1.3 billion, respectively, for receivables and operating lease equipment. Operating agreements specify that Textron Finance generally has recourse to Textron Manufacturing for outstanding balances from these transactions. At year-end 2001 and 2000, the amounts guaranteed by Textron Manufacturing totaled \$652 million and \$903 million, respectively. Included in the finance receivables guaranteed by Textron Manufacturing are past due loans of \$90 million at the end of 2001 (\$105 million at year-end 2000) that meet the non-accrual criteria but are not classified as non-accrual by Textron Finance due to the guarantee. Textron Finance continues to recognize income on these loans. Concurrently, Textron Manufacturing is charged for their obligation to Textron Finance under the guarantee so that there are no net interest earnings for the loans on a consolidated basis. Textron Manufacturing has established reserves for losses related to these guarantees which are included in other current liabilities.

### Securitizations

Textron Finance securitized and sold (with servicing rights retained) \$1.3 billion and \$1.2 billion of finance receivables in 2001 and 2000, respectively. Gains from securitized trust sales were approximately \$43 million and \$22 million in 2001 and 2000, respectively, and proceeds were approximately \$1.3 billion and \$1.1 billion, respectively. At year-end 2001, \$2.3 billion in securitized loans were outstanding with \$69 million in past due loans. Textron Finance has securitized certain receivables generated by Textron Manufacturing for which it has retained full recourse to Textron Manufacturing.

Textron Finance retained subordinated interests in the trusts which are approximately 2% to 10% of the total trust. Servicing fees range from 30 to 150 basis points. During 2001, key economic assumptions used in measuring the retained interests at the date of each securitization included prepayment speeds ranging from 7.5% to 20%, weighted average lives ranging from 0.3 to 8.9 years, expected credit losses ranging from 0.2% to 1.5%, and residual cash flows discount rates ranging from 7.1% to 11%. At year-end 2001, key economic assumptions used in measuring these retained interests were as follows:

	Equipment				
	Aircraft Loans	Loans and Leases	Franchise Loans	Land Loan Receivables	Floorplan Loans
<i>(Dollars in millions)</i>					
Carrying amount of retained interests in securitizations, net	\$67	\$41	\$37	\$20	\$68
Weighted-average life (in years)	3.6	1.8	8.0	8.9	0.3
Prepayment speed (annual rate)	21.0%	6.6%	8.0%	20.0%	-
Expected credit losses (annual rate)	0.2%	0.2%	0.3%	1.5%	1.0%
Residual cash flows discounted at	8.2%	7.0%	9.0%	11.0%	9.0%

Hypothetical adverse changes of 10% and 20% to either the prepayment speed, expected credit losses and residual cash flows discount rates assumptions would not have a material impact on the current fair value of the residual cash flows associated with the retained interests. These hypothetical sensitivities should be used with caution as the effect of a variation in a particular assumption on the fair value of the retained interest is calculated without changing any other assumption. In reality, changes in one factor may result in another that may magnify or counteract the sensitivities losses, such as increases in market interest rates may result in lower prepayments and increased credit losses.

## 4. Inventories

	December 29, 2001	December 30, 2000
<i>(In millions)</i>		
Finished goods	\$ 719	\$ 727
Work in process	856	930
Raw materials	377	454
	<b>1,952</b>	2,111
Less progress payments and customer deposits	225	240
	<b>\$1,727</b>	\$1,871

Inventories aggregating \$1.0 billion and \$1.2 billion at year-end 2001 and 2000, respectively, were valued by the last-in, first-out (LIFO) method. Had such LIFO inventories been valued at current costs, their carrying values would have been approximately \$188 million and \$192 million higher at those respective dates. During the fourth quarter of 2001, certain inventory quantities were reduced, which resulted in a liquidation of LIFO inventory layers carried at lower costs from prior years. The effect of the liquidation was

to decrease the cost of sales by approximately \$16 million and to increase net income by approximately \$10 million. The remaining inventories, other than those related to certain long-term contracts, are valued primarily by the first-in, first-out method. Inventories related to long-term contracts, net of progress payments and customer deposits, were \$105 million at year-end 2001 and \$161 million at year-end 2000.

## 5. Long-Term Contracts

Long-term contract receivables at year-end 2001 and 2000 totaled \$264 million and \$199 million, respectively. This includes \$220 million and \$135 million, respectively, of unbilled costs and accrued profits that had not yet met the contractual billing criteria. Long-term contract receivables do not include significant amounts (a) billed but unpaid due to contractual retainage provisions or (b) subject to collection uncertainty. During the second half of 2001, program reviews on certain long-term development and production contracts indicated reduced profitability expectations resulting in a \$124 million charge to earnings. The reduced profitability expectations reflected the clarification of several matters including extended development schedules and planned design changes on a number of programs, as well as ongoing development efforts.

## 6. Long-Term Assets

Property, plant and equipment for Textron Manufacturing at year-end 2001 and 2000 consisted of the following:

<i>(In millions)</i>	<b>December 29, 2001</b>	December 30, 2000
Land and buildings	<b>\$1,011</b>	\$ 1,166
Machinery and equipment	<b>2,962</b>	3,666
	<b>3,973</b>	4,832
Less accumulated depreciation	<b>1,929</b>	2,264
	<b>\$ 2,044</b>	\$ 2,568

Prior to 2000, customer engineering and tooling project costs for which customer reimbursement was anticipated, were capitalized and classified in other assets. In 2000, Textron adopted the EITF consensus, Issue No. 99-5 "Accounting for Pre-Production Costs Related to Long-Term Supply Arrangements." This consensus requires that all design and development costs for products sold under long-term supply arrangements be expensed unless there is a contractual guarantee that provides for specific required payments for these costs. Textron reported a cumulative effect of a change in accounting principle of \$59 million, net of tax, related to the adoption of this consensus.

Pro forma income from continuing operations, net income and related diluted earnings per common share amounts as if the provisions of EITF No. 99-5 had been applied during the year ended 1999 were:

<i>(In millions, except per share data)</i>	As Reported	Pro Forma
Income from continuing operations	\$ 623	\$ 612
Income from continuing operations per diluted share	\$ 4.05	\$ 3.98
Net income	\$2,226	\$2,215
Net income per diluted share	\$14.48	\$14.41

## 7. Debt and Credit Facilities

Debt at year-end 2001 and 2000 consisted of the following:

<i>(In millions)</i>	<b>December 29, 2001</b>	December 30, 2000
<b>Textron Manufacturing:</b>		
Short-term debt:		
Borrowings under or supported by long-term credit facilities*	<b>\$ 146</b>	\$ 528
Current portion of long-term debt	<b>527</b>	87
Total short-term debt	<b>673</b>	615
Long-term senior debt:		
Medium term notes due 2010-2011 (average rate – 9.85%)	<b>16</b>	43
6.750% due 2002	<b>500</b>	500
6.375% due 2004	<b>300</b>	300
5.625% due 2005	<b>270</b>	273
6.375% due 2008	<b>300</b>	–
6.625% due 2020	<b>217</b>	221
Other long-term debt (average rate – 6.77%)	<b>185</b>	219
	<b>1,788</b>	1,556
Current portion of long-term debt	<b>(527)</b>	(87)
Total long-term debt	<b>1,261</b>	1,469
Total Textron Manufacturing debt	<b>\$ 1,934</b>	\$ 2,084

\*The weighted average interest rates on these borrowings, before the effect of interest rate exchange agreements, were 3.2%, 5.6% and 5.8% at year-end 2001, 2000 and 1999, respectively. Comparable rates during the years 2001, 2000 and 1999 were 4.3%, 5.7% and 4.9%, respectively.

Textron Manufacturing maintains credit facilities with various banks for both short- and long-term borrowings. At year-end, Textron Manufacturing had (a) a \$1.0 billion domestic credit agreement with 21 banks available on a revolving basis until April 2003, (b) a \$600 million domestic credit agreement with five banks available through May 2002 and (c) \$71 million in multi-currency agreements with two banks available through December 2002. At year-end 2001, \$1.5 billion of the credit facilities was not used or reserved as support for commercial paper or bank borrowings.

<i>(In millions)</i>	<b>December 29, 2001</b>	December 30, 2000
<b>Textron Finance:</b>		
Borrowings under or supported by credit facilities*	<b>\$ 688</b>	\$ 966
6.84% average rate debt; due 2002 to 2004	<b>1,512</b>	1,432
2.41% average rate variable notes; due 2002 to 2004	<b>1,988</b>	2,269
<b>Total Textron Finance debt</b>	<b>\$4,188</b>	\$4,667

\*The weighted average interest rates on these borrowings, before the effect of interest rate exchange agreements, were 2.5%, 6.7% and 6.4% at year-end 2001, 2000 and 1999, respectively. Comparable rates during the years 2001, 2000 and 1999 were 4.2%, 6.4% and 5.4%, respectively.

Textron Finance has its primary lines of credit with various banks aggregating \$1.5 billion at year-end 2001, of which \$500 million will expire in 2002 and \$1.0 billion will expire in 2006. Of these lines, \$875 million was not used or reserved as support for commercial paper or bank borrowings. Lending agreements limit Textron Finance's net assets available for cash dividends and other payments to Textron Manufacturing to approximately \$452 million of Textron Finance's net assets of \$1,009 million at year-end 2001. Textron Finance's loan agreements also contain provisions regarding additional debt, creation of liens or guarantees and the making of investments.

The following table shows required payments during the next five years on debt outstanding at the end of 2001. The payment schedule excludes amounts that are payable under or supported by long-term credit facilities.

<i>(In millions)</i>	2002	2003	2004	2005	2006
Textron Manufacturing	\$ 527	\$ 10	\$ 307	\$273	\$ 3
Textron Finance	1,580	983	938	-	-
	<b>\$2,107</b>	<b>\$993</b>	<b>\$1,245</b>	<b>\$273</b>	<b>\$3</b>

Textron Manufacturing has agreed to cause Textron Finance to maintain certain minimum levels of financial performance. No payments from Textron Manufacturing were necessary in 2001, 2000 or 1999 for Textron Finance to meet these standards.

#### **Due to Textron Manufacturing**

On December 20, 2001, Textron Manufacturing entered into a promissory demand note agreement with Textron Finance, whereby Textron Finance can borrow up to \$600 million. At year-end 2001, the amount outstanding under this agreement is \$510 million which has not been eliminated, and is included in total assets and total liabilities on the consolidated balance sheet. This note was repaid in January 2002.

#### **Extraordinary Loss from Debt Retirement**

During 1999, Textron retired \$553 million of long-term high-coupon debt and terminated \$479 million of interest rate exchange agreements designated as hedges of the retired borrowings. As a result of this retirement, Textron recorded an after-tax loss in 1999 of \$43 million, which has been reflected as an extraordinary item.

## **8. Derivatives and Other Financial Instruments**

### **Interest Rate Hedging**

Textron Manufacturing's policy is to manage interest cost using a mix of fixed- and variable-rate debt. To manage this mix in a cost efficient manner, Textron Manufacturing will enter into interest rate swaps to agree to exchange, at specified intervals, the difference between fixed and variable interest amounts calculated by reference to an agreed-upon notional principal amount. The mark-to-market values of both the fair value hedge instruments and underlying debt obligations are recorded as equal and offsetting unrealized gains and losses in interest expense. At December 31, 2000, Textron Manufacturing had swaps with a fair value of \$8 million designated as fair value hedges of underlying fixed-rate debt obligations which was recorded as a reduction of debt. In March 2001, Textron Manufacturing terminated all

outstanding interest rate swaps and received a payment of \$15 million which is being amortized into income over the remaining life of the original hedged debt. Textron Manufacturing had no outstanding interest rate swaps at year-end 2001.

Textron Finance entered into interest rate swap agreements to mitigate its exposure to interest rate changes by converting certain of its fixed-rate receivables and debt issues to floating rates. The agreements require Textron Finance to pay fixed-rate amounts in exchange for floating-rate amounts based on specified notional amounts. Textron Finance has designated these agreements fair value hedges. Textron Finance has also entered into interest rate swap, cap and floor agreements to mitigate its exposure on interest-only securities resulting from securitizations. The swap agreements require Textron Finance to make periodic variable payments in exchange for periodic fixed-rate receipts and vice versa based on specified notional amounts. The cap and floor agreements require the payment of variable-rate amounts based on specified notional amounts if interest rates exceed or fall below specified rates. These agreements are designated as cash flow hedges. For cash flow hedges during 2001, Textron Finance recorded a charge of \$11 million, net of taxes, to accumulated OCL with no impact to the statement of income. For fair value hedges at December 29, 2001, Textron Finance had interest exchange agreements with a fair value liability of \$6 million designated as fair value hedges of a fixed-rate receivable portfolio and debt. The fair value hedges are highly effective resulting in an immaterial net impact to earnings due to hedge ineffectiveness.

Interest rate swap agreements are summarized as follows:

	December 29, 2001			December 30, 2000		
	Notional Amount	Weighted Average Interest Rate	Weighted Average Remaining Term (in Years)	Notional Amount	Weighted Average Interest Rate	Weighted Average Remaining Term (in Years)
<i>(Dollars in millions)</i>						
<b>Textron Manufacturing:</b>						
Variable-pay swaps	-	-	-	\$ 415	6.91%	3.9
<b>Textron Finance:</b>						
Fixed-pay swaps – debt	-	-	-	\$ 150	6.52%	2.0
Variable-pay swaps – debt	<b>\$ 370</b>	<b>1.88%</b>	<b>0.6</b>	-	-	-
Variable-receive						
swaps – receivables	<b>\$ 97</b>	<b>8.14%</b>	<b>12.0</b>	\$ 100	8.14%	12.6
Basis swaps*	-	-	-	\$ 715	6.77%	0.8
Forward starting						
fixed-pay swaps	-	-	-	\$ 228	7.31%	7.6

\*Amounts at December 30, 2000 require U.S. Prime Rate-based payments, as stated above, and LIBOR-based receipts of 6.77%.

In addition, Textron Finance utilizes interest rate agreements to protect against the interest rate risk associated with their retained interest in securitized assets. At year-end 2001 and 2000, Textron Finance had \$675 million and \$509 million, respectively, of such agreements outstanding. During 2001, Textron also entered into an interest rate agreement tied to the one-month LIBOR for \$337 million that caps the weighted average rate at 6.35%. Textron had minimal exposure to loss from nonperformance by the counterparties to its interest rate swaps at the end of 2001, and does not anticipate nonperformance by counterparties in the periodic settlements of amounts due. Textron currently minimizes this potential for risk by entering into contracts exclusively with major, financially sound counterparties having no less than a long-term bond rating of "A," by continuously monitoring the counterparties' credit ratings and by limiting exposure with any one financial institution. The credit risk generally is limited to the amount by which the counterparties' contractual obligations exceed Textron's obligations to the counterparty.

### Currency Rate Hedging

Textron manufactures and sells its products in a number of countries throughout the world and, as a result, is exposed to movements in foreign currency exchange rates. The primary purpose of Textron's foreign currency hedging activities is to manage the volatility associated with foreign currency purchases of materials, foreign currency sales of its products and other assets and liabilities created in the normal course of business. Textron primarily utilizes forward exchange contracts and purchased options with maturities of no more than 18 months that qualify as cash flow hedges. These are intended to offset the effect of exchange rate fluctuations on forecasted sales, inventory purchases and overhead expenses. The fair value of these instruments at December 29, 2001 was a \$9 million liability. At year-end 2001, \$7 million of after-tax loss was reported in accumulated OCL from qualifying cash flow hedges. This loss is generally

expected to be reclassified to earnings in the next 12 months as the underlying transactions occur. Textron Manufacturing also enters into certain foreign currency derivative instruments that do not meet hedge accounting criteria, and are primarily intended to protect against exposure related to intercompany financing transactions and income from international operations. The fair value of these instruments at year-end 2001 and the net impact of the related gains and losses on selling and administrative expense was not material in 2001.

The table below summarizes, by major currency, Textron Manufacturing's forward exchange contracts in U.S. dollars. The buy and sell amounts represent the U.S. dollar equivalent of commitments to purchase and sell foreign currencies. The foreign currency amounts have been translated into a U.S. dollar equivalent using the exchange rate at the balance sheet date.

	Buy Contracts		Sell Contracts	
	Contract Amount	Unrealized Gain/(Loss)	Contract Amount	Unrealized Gain/(Loss)
<i>(In millions)</i>				
<b>December 29, 2001</b>				
British Pound	\$ 7	\$ -	\$ -	\$ -
Canadian Dollar	217	(7)	23	-
Euro	23	(3)	67	-
Other	106	-	162	-
Total	\$353	\$(10)	\$252	\$ -
<b>December 30, 2000</b>				
British Pound	\$208	\$ (1)	\$105	\$ -
Canadian Dollar	281	-	15	-
Euro	116	-	51	-
Other	26	-	38	1
Total	\$631	\$ (1)	\$209	\$ 1

#### Net Investment Hedging

Textron hedges its net investment position in major currencies and generates foreign currency interest payments, that offset other transactional exposures in these currencies. To accomplish this, Textron borrows directly in foreign currency and designates a portion of foreign currency debt as a hedge of net investments. In addition, certain currency forwards are designated as hedges of Textron's related foreign net investments. Currency effects of these hedges which are reflected in the cumulative translation adjustment account within OCL, produced a \$9 million after-tax gain during 2001, leaving an accumulated net balance of \$36 million.

#### Stock-based Compensation Hedging

Textron manages the expense related to stock-based compensation awards using cash settlement forward contracts on its common stock. The use of these forward contracts modifies Textron's compensation expense exposure to changes in the stock price with the intent to reduce potential variability. The fair value of these instruments at December 29, 2001 was a \$11 million liability. Gains and losses on these instruments are recorded as an adjustment to compensation expense when the award is charged to expense. These contracts generated expense of \$22 million and \$69 million in 2001 and 2000, respectively, and income of approximately \$5 million in 1999.

#### Fair Values of Financial Instruments

The carrying amounts and estimated fair values of Textron's financial instruments that are not reflected in the financial statements at fair value as a matter of accounting policy, are as follows:

	December 29, 2001		December 30, 2000	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<i>(In millions)</i>				
<b>Textron Manufacturing:</b>				
Debt	\$ (1,934)	\$ (1,972)	\$ (2,061)	\$ (2,105)
<b>Textron Finance:</b>				
Finance receivables	4,795	4,884	4,767	4,840
Debt	(4,188)	(4,208)	(4,667)	(4,688)

**9. Textron Finance – Obligated Mandatorily Redeemable Preferred Securities of Finance Subsidiary Holding Solely Junior Subordinated Debentures**

Litchfield Financial Corporation (Litchfield, a subsidiary of Textron Financial Corporation) was acquired by Textron Financial Corporation during 1999. Prior to the acquisition, a trust sponsored and wholly owned by Litchfield issued Series A Preferred Securities to the public (for \$26 million), the proceeds of which were invested by the trust in \$26 million aggregate principal amount of Litchfield's newly issued 10% Series A Junior Subordinated Debentures (Series A Debentures), due 2029. The debentures are the sole asset of the trust. The preferred securities were recorded by Textron Financial Corporation at the fair value of \$29 million as of the acquisition date. The amounts due to the trust under the subordinated debentures and the related income statement amounts have been eliminated in Textron's consolidated financial statements.

The preferred securities accrue and pay cash distributions quarterly at a rate of 10% per annum. The trust's obligation under the Series A Preferred Securities is fully and unconditionally guaranteed by Litchfield. The trust will redeem all of the outstanding Series A 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 its acquisition of Litchfield, Textron Financial Corporation 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 subsidiary.

**10. Textron – Obligated Mandatorily Redeemable Preferred Securities of Subsidiary Trust Holding Solely Textron Junior Subordinated Debt Securities**

In 1996, a trust sponsored and wholly owned by Textron issued preferred securities to the public (for \$500 million) and shares of its common securities to Textron (for \$15.5 million), the proceeds of which were invested by the trust in \$515.5 million aggregate principal amount of Textron's newly issued 7.92% Junior Subordinated Deferrable Interest Debentures, due 2045. The debentures are the sole asset of the trust. The proceeds from the issuance of the debentures were used by Textron for the repayment of long-term borrowings and for general corporate purposes. The amounts due to the trust under the debentures and the related income statement amounts have been eliminated in Textron's consolidated financial statements.

The preferred securities accrue and pay cash distributions quarterly at a rate of 7.92% per annum. Textron has guaranteed, on a subordinated basis, distributions and other payments due on the preferred securities. The guarantee, when taken together with Textron's obligations under the debentures and in the indenture pursuant to which the debentures were issued and Textron's obligations under the Amended and Restated Declaration of Trust governing the trust, provides a full and unconditional guarantee of amounts due on the preferred securities. The preferred securities are mandatorily redeemable upon the maturity of the debentures on March 31, 2045, or earlier to the extent of any redemption by Textron of any debentures. The redemption price in either such case will be \$25 per share plus accrued and unpaid distributions to the date fixed for redemption.

**11. Shareholders' Equity**

**Capital Stock**

Textron has authorization for 15,000,000 shares of preferred stock and 500,000,000 shares of 12.5 cent per share par value common stock. Each share of \$2.08 Preferred Stock (\$23.63 approximate stated value) is convertible into 4.4 shares of common stock and can be redeemed by Textron for \$50 per share. Each share of \$1.40 Preferred Dividend Stock (\$11.82 approximate stated value) is convertible into 3.6 shares of common stock and can be redeemed by Textron for \$45 per share.

**Performance Share Units and Stock Options**

Textron's 1999 Long-Term Incentive Plan (the "1999 Plan") authorizes awards to key employees of Textron and its related companies in three forms: (a) options to purchase Textron shares; (b) performance share units and (c) restricted stock. In 2001, Textron's Board of Directors amended the 1999 Plan to revise the maximum number of share awards authorized as follows: (a) 12,200,000 options to purchase Textron shares; (b) 2,000,000 performance units and (c) 500,000 shares of restricted stock.

Pro forma information regarding net income and earnings per share has been determined using the fair value method. For the purpose of developing the pro forma information, the fair values of options granted after 1995 are estimated at the date of grant using the Black-Scholes option-pricing model. The estimated fair values are amortized to expense over the options' vesting period. Using this methodology, net income would have been reduced by \$26 million or \$0.18 per diluted share in 2001, \$25 million or \$0.17 per diluted share in 2000, and \$9 million or \$0.06 per diluted share in 1999.

The assumptions used to estimate the fair value of an option granted in 2001, 2000 and 1999, respectively, are approximately as follows: dividend yield of approximately 3%, 3% and 2%; expected volatility of 34%, 27% and 22%; risk-free interest rates of 4%, 5% and 6%, and weighted average expected lives of 3.5 years. Under these assumptions, the weighted-average fair value of an option to purchase one share granted in 2001, 2000 and 1999 was approximately \$11, \$10 and \$15, respectively.

At year-end 2001, 6,139,000 stock options were available for future grant under the 1999 Plan as amended. Stock option activity is summarized as follows:

<i>(Shares in thousands)</i>	2001		2000		1999	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	12,631	\$52.32	8,822	\$55.26	8,342	\$47.23
Granted	315	\$50.93	4,618	\$46.31	2,176	\$73.75
Exercised	(884)	\$30.20	(440)	\$30.67	(1,451)	\$34.86
Canceled	(1,086)	\$58.01	(369)	\$76.41	(245)	\$67.06
Outstanding at end of year	10,976	\$53.50	12,631	\$52.32	8,822	\$55.26
Exercisable at end of year	8,653	\$55.33	7,012	\$53.25	5,815	\$45.60

Stock options outstanding at year-end 2001 are summarized as follows:

<i>(Shares in thousands)</i>	Outstanding	Weighted Average Remaining Contractual	Weighted Average Exercise	Exercisable	Weighted Average Exercise
		Life (in Years)	Price		Price
\$ 17 – \$ 37	1,542	3.1	\$29.61	1,507	\$29.83
\$ 38 – \$ 63	6,212	7.9	\$48.75	3,935	\$49.80
\$ 64 – \$ 94	3,222	7.5	\$73.94	3,211	\$73.96

#### Reserved Shares of Common Stock

At year-end 2001, common stock reserved for the subsequent conversion of preferred stock and shares reserved for the exercise of stock options were 2,865,000 and 10,976,000, respectively.

#### Preferred Stock Purchase Rights

Each outstanding share of Textron common stock has attached to it one-half of a preferred stock purchase right. One preferred stock purchase right entitles the holder to buy one one-hundredth of a share of Series C Junior Participating Preferred Stock at an exercise price of \$250. The rights become exercisable only under certain circumstances related to a person or group acquiring or offering to acquire a substantial block of Textron's common stock. In certain circumstances, holders may acquire Textron stock, or in some cases the stock of an acquiring entity, with a value equal to twice the exercise price. The rights expire in September 2005 but may be redeemed earlier for \$.05 per right.

#### Income per Common Share

A reconciliation of income from continuing operations and basic to diluted share amounts is presented below.

<i>(Dollars in millions, shares in thousands)</i>	2001		2000		1999	
	Income	Average Shares	Income	Average Shares	Income	Average Shares
Income from continuing operations	\$166		\$277		\$623	
Less: Preferred stock dividends	(1)		-		(1)	
<b>Basic</b>						
Available to common shareholders	165	141,050	277	143,923	622	150,389
Dilutive effect of convertible preferred stock and stock options	1	1,887	-	2,227	1	3,365
<b>Diluted</b>						
Available to common shareholders and assumed conversions	\$166	142,937	\$277	146,150	\$623	153,754

## Accumulated Other Comprehensive Loss (OCL)

The components of Textron's accumulated OCL is as follows:

<i>(In millions)</i>	Currency Translation Adjustment	Unrealized Gains (Losses) on Securities	Pension Liability Adjustment	Deferred Losses on Hedge Contracts	Accumulated OCL
Balance at January 2, 1999	\$ (104)	\$ 13	\$ (5)	\$ -	\$ (96)
Change, net of income taxes	(71)	-	3	-	(68)
AFS disposal, net of income taxes	79	(13)	-	-	66
Balance at January 1, 2000	(96)	-	(2)	-	(98)
Change, net of income taxes	(74)	-	-	-	(74)
Net unrealized losses*	-	(59)	-	-	(59)
Reclassification adjustment*	-	59	-	-	59
Balance at December 30, 2000	(170)	-	(2)	-	(172)
Transition adjustment due to change in accounting for derivative instruments and hedging, net of taxes	-	-	-	(15)	(15)
Change, net of income taxes	(31)	1	-	(17)	(47)
Automotive Trim disposal, net of income taxes	11	-	-	-	11
Net unrealized losses*	-	(6)	-	-	(6)
Reclassification adjustment*	-	6	-	-	6
Balance at December 29, 2001	<b>\$ (190)</b>	<b>\$ 1</b>	<b>\$(2)</b>	<b>\$(32)</b>	<b>\$(223)</b>

\*Net of income tax benefit of \$3 million and \$31 million for 2001 and 2000, respectively.

## 12. Pension Benefits and Postretirement Benefits Other Than Pensions

Textron has defined benefit and defined contribution pension plans that together cover substantially all employees. The costs of the defined contribution plans amounted to approximately \$48 million in 2001, \$51 million in 2000 and \$40 million in 1999. Defined benefits under salaried plans are based on salary and years of service. Hourly plans generally provide benefits based on stated amounts for each year of service. Textron's funding policy is consistent with federal law and regulations. Pension plan assets consist principally of corporate and government bonds and common stocks. Textron offers health care and life insurance benefits for certain retired employees.

The following summarizes the change in the benefit obligation; the change in plan assets; the funded status; and reconciliation to the amount recognized in the balance sheet for the pension and postretirement benefit plans:

<i>(In millions)</i>	Pension Benefits		Postretirement Benefits Other than Pensions	
	December 29, 2001	December 30, 2000	December 29, 2001	December 30, 2000
<b>Change in benefit obligation</b>				
Benefit obligation at beginning of year	<b>\$ 3,941</b>	\$ 3,665	<b>\$ 612</b>	\$ 603
Service cost	<b>109</b>	101	<b>6</b>	6
Interest cost	<b>282</b>	265	<b>49</b>	45
Amendments	<b>34</b>	110	<b>(14)</b>	(5)
Net effect of acquisitions/dispositions	<b>(220)</b>	4	<b>(65)</b>	-
Plan participants' contributions	<b>4</b>	4	<b>5</b>	5
Actuarial losses	<b>28</b>	80	<b>113</b>	27
Benefits paid	<b>(258)</b>	(249)	<b>(70)</b>	(68)
Foreign exchange rate changes	<b>(11)</b>	(39)	<b>(1)</b>	-
Curtailments	<b>(1)</b>	-	<b>(3)</b>	(1)
Benefit obligation at end of year	<b>\$ 3,908</b>	\$ 3,941	<b>\$ 632</b>	\$ 612

	Pension Benefits		Postretirement Benefits Other than Pensions	
	December 29, 2001	December 30, 2000	December 29, 2001	December 30, 2000
<i>(In millions)</i>				
<b>Change in plan assets</b>				
Fair value of plan assets at beginning of year	\$ 5,170	\$ 5,342	\$ -	\$ -
Actual return on plan assets	(218)	77	-	-
Employer contributions	22	41	-	-
Plan participants' contributions	4	4	-	-
Net effect of acquisitions/dispositions	(229)	3	-	-
Benefits paid	(258)	(249)	-	-
Foreign exchange rate changes	(11)	(48)	-	-
Fair value of plan assets at end of year	\$ 4,480	\$ 5,170	\$ -	\$ -
Funded status of the plan	\$ 572	\$ 1,229	\$ (632)	\$ (612)
Unrecognized actuarial gain	(133)	(871)	26	(88)
Unrecognized prior service cost	162	154	(20)	(15)
Unrecognized transition net asset	(23)	(43)	-	-
Net amount recognized in the balance sheet	\$ 578	\$ 469	\$ (626)	\$ (715)
Amounts recognized in the balance sheet consists of:				
Prepaid benefit cost	\$ 745	\$ 621	\$ -	\$ -
Accrued benefit liability	(171)	(156)	(626)	(715)
Intangible asset	2	2	-	-
Accumulated OCL	2	2	-	-
Net amount recognized in the balance sheet	\$ 578	\$ 469	\$ (626)	\$ (715)

The projected benefit obligation, accumulated benefit obligation and fair value of plan assets for the pension plans with accumulated benefit obligations in excess of plan assets were \$248 million, \$209 million and \$42 million, respectively, as of year-end 2001, and \$199 million, \$161 million and \$10 million, respectively, as of year-end 2000.

The following summarizes the net periodic benefit cost for the pension benefits and postretirement benefits plans:

	Pension Benefits			Postretirement Benefits Other than Pensions		
	December 29, 2001	December 30, 2000	January 2, 2000	December 29, 2001	December 30, 2000	January 2, 2000
<i>(In millions)</i>						
<b>Components of net periodic benefit cost</b>						
Service cost	\$ 109	\$ 101	\$ 109	\$ 6	\$ 6	\$ 7
Interest cost	282	265	252	49	45	41
Expected return on plan assets	(454)	(423)	(378)	-	-	-
Amortization of unrecognized transition asset	(17)	(17)	(17)	-	-	-
Recognized actuarial (gain)/loss	(30)	(24)	2	(2)	(8)	(10)
Recognized prior service cost	20	14	16	(6)	(4)	(4)
Curtailments	(6)	-	-	(5)	(1)	-
Net periodic benefit cost	\$ (96)	\$ (84)	\$ (16)	\$ 42	\$ 38	\$ 34

Recognized actuarial (gain)/loss on net pension benefits is being amortized over a twelve-year period.

Major actuarial assumptions used in accounting for defined benefit pension plans are presented below.

	December 29, 2001	December 30, 2000	January 1, 2000	January 2, 1999
Discount rate	7.25%	7.50%	7.50%	6.75%
Expected rate of return on plan assets	9.25	9.25	9.25	9.25
Annual rate of compensation increase	4.50	4.80	4.80	4.80

Postretirement benefit plan discount rates are the same as those used by Textron's defined benefit pension plans.

The 2001 health care cost trend rate, which is the weighted average annual assumed rate of increase in the per capita cost of covered benefits, was 8% for all retirees. This rate is assumed to decrease to 5.5% by 2005 and then remain at that level. A one-percentage-point change in assumed health care cost trend rate would have the following effects:

<i>(In millions)</i>	1% Increase	1% Decrease
Effect on total of service and interest cost components	\$ 5	\$ (4)
Effect on postretirement benefit obligation	\$54	\$(47)

### 13. Income Taxes

Textron files a consolidated federal income tax return for all U.S. subsidiaries and separate returns for foreign subsidiaries.

Income from continuing operations before income taxes and distributions on preferred securities of subsidiary trusts is as follows:

<i>(In millions)</i>	2001	2000	1999
United States	\$ 451	\$ 366	\$ 831
Foreign	(32)	245	199
Total	\$ 419	\$ 611	\$ 1,030

Income tax expense is summarized as follows:

<i>(In millions)</i>	2001	2000	1999
Federal:			
Current	\$ 136	\$ 246	\$ 222
Deferred	48	(37)	54
State	26	35	36
Foreign	17	64	69
Income tax expense	\$ 227	\$ 308	\$ 381

The following reconciles the federal statutory income tax rate to the effective income tax rate reflected in the consolidated statements of income:

	2001	2000	1999
Federal statutory income tax rate	35.0%	35.0%	35.0%
Increase (decrease) in taxes resulting from:			
State income taxes	2.7	3.8	2.3
Goodwill	22.3	19.0	2.2
Permanent items from Automotive Trim disposition	2.7	-	-
Foreign tax rate differential	(0.9)	(2.2)	0.6
Foreign sales corporation benefit	(2.9)	(1.9)	(0.9)
Other, net	(4.7)	(3.3)	(2.2)
Effective income tax rate	54.2%	50.4%	37.0%

Textron's net deferred tax asset consisted of gross deferred tax assets of \$1.7 billion and gross deferred tax liabilities of \$1.7 billion at year-end 2001 and \$1.7 billion and \$1.5 billion, respectively, at year-end 2000. The tax effects of temporary differences that give rise to significant portions of Textron's net deferred tax assets and liabilities were as follows:

<i>(In millions)</i>	December 29, 2001	December 30, 2000
Deferred tax assets:		
Self insured liabilities, (including environmental)	\$ 110	\$ 146
Deferred compensation	140	140
Obligation for postretirement benefits	44	118
Investment securities	9	45
Allowance for credit losses	49	44
Amortization of goodwill and other intangibles	30	37
Other, principally timing of other expense deductions	280	278
Total deferred tax assets	\$ 662	\$ 808
Deferred tax liabilities:		
Textron Finance transactions, principally leasing	\$ (387)	\$ (366)
Fixed assets, principally depreciation	(150)	(190)
Inventory	(59)	(53)
Currency translation adjustment	(29)	(26)
Total deferred tax liabilities	(625)	(635)
Net deferred tax assets	\$ 37	\$ 173

Deferred income taxes have not been provided for the undistributed earnings of foreign subsidiaries, which approximated \$488 million at year-end 2001. Management intends to reinvest those earnings for an indefinite period, except for distributions having an immaterial tax effect. If foreign subsidiaries' earnings were distributed, 2001 taxes, net of foreign tax credits, would be increased by approximately \$61 million.

## 14. Special Charges, Net

### Goodwill and Other Intangible Assets

In conjunction with Textron's restructuring activities and review of long-lived assets, Textron wrote down goodwill and other intangible assets by \$319 million and \$349 million in 2001 and 2000, respectively. For 2001, the impairment charge related primarily to OmniQuip within the Industrial Products segment. For 2000, Textron recognized goodwill impairment charges of \$194 million in Industrial Products primarily related to Turbine Engine Components Textron (TECT), \$128 million in Fastening Systems primarily related to Flexalloy, and \$27 million in Automotive.

During the third quarter of 2001, certain long-lived asset impairment indicators were identified for OmniQuip which caused Textron to perform an impairment review. Key impairment indicators included OmniQuip's operating performance against plan despite restructuring efforts to improve operating efficiencies and streamline operations. Additionally, the strategic review process completed in August 2001 confirmed that the economic and market conditions combined with the saturation of light construction equipment handlers in the market had negatively impacted the projected results for the foreseeable future. The undiscounted cash flow projections performed were less than the carrying amount of OmniQuip's long-lived assets indicating that there was an impairment. Textron used a discounted pre-tax cash flow calculation in determining the fair value of the long-lived assets utilizing the multi-year forecast to project future cash flows and a risk-based rate of 11%. The calculation resulted in an impairment charge of \$317 million, including goodwill of \$306 million and other intangible assets of \$11 million.

For 2000, indicators of potential impairment of long-lived assets were identified in connection with multi-year financial planning, as well as the initiation of the current restructuring program. Based on the indicators, Textron performed an overall impairment review for the applicable operating units. Key indicators with respect to TECT, a manufacturer of air- and land-based gas turbine engines components and airframe structures, were deteriorating margins and its inability to generate new contracts that had resulted in a significantly decreased revenue base. Key indicators for Flexalloy, a vendor-managed inventory company, serving primarily the heavy truck industry within Fastening Systems, were its performance against plan and the negative effect on its vendor-managed business model by other supply-chain competitors. The business is dependent upon large customers, and the service level for larger customers cannot be easily replicated over a large number of smaller customers without significant additional investment. Also, the synergies within Fastening Systems, which were initially viewed to be significant due to Textron's existing market share, were considerably less than anticipated. Accordingly, future cash flow projections were not expected to achieve the level of growth originally anticipated at the time of Flexalloy's acquisition.

The undiscounted cash flow projections performed for the applicable operating units were less than the carrying amounts of long-lived assets indicating that there was an impairment. The discounted pre-tax cash flow calculations for purposes of determining the fair value of the long-lived assets were performed utilizing the multi-year financial plan (adjusted for planned restructuring activities) to project future cash flows and a risk-based rate of 11%. The calculation resulted in a fourth quarter 2000 write down of goodwill for TECT of \$178 million, Flexalloy of \$96 million and \$75 million related to other operating units.

The cash flow projections used in performing the review for these operating units were based upon management's best estimate of future results. Actual results could differ materially from those estimates.

### Restructuring

To improve returns at core businesses and to complete the integration of certain acquisitions, Textron approved and committed to a restructuring program in the fourth quarter of 2000 based upon targeted cost reductions. The program includes corporate and segment direct and indirect workforce reductions, consolidation of facilities primarily in the United States and Europe, rationalization of certain product lines, outsourcing of non-core production activity, the divestiture of non-core businesses and streamlining of sales and administrative overhead.

In 2001, Textron recorded restructuring expenses of \$109 million in special charges. These restructuring costs included \$81 million of severance and related benefits, and other exit costs (\$27 million for Industrial Products, \$25 million for Fastening Systems, \$14 million for Automotive, \$5 million for Aircraft, \$3 million for Finance and \$7 million at Corporate) and \$28 million for fixed asset impairment write-downs, primarily

at Fastening Systems. As of December 29, 2001, Textron has reduced its workforce by approximately 5,700 employees and has closed 44 facilities, including 18 manufacturing plants, primarily in the Industrial Products and Fastening Systems segments. In 2000, Textron recorded restructuring costs of \$15 million in Industrial Products and \$2 million in Automotive for fixed asset impairment, severance-related benefits and certain other exit costs.

An analysis of Textron's special charges for restructuring and related reserve accounts for its current program is summarized below:

<i>(In millions)</i>	<b>Asset Impairments</b>	<b>Severance</b>	<b>Facilities &amp; Other</b>	<b>Total</b>
Charges	\$ 1	\$ 15	\$ 1	\$ 17
Utilized	(1)	(1)	-	(2)
Balance at December 30, 2000	\$ -	\$ 14	\$ 1	\$ 15
Charges	<b>28</b>	<b>77</b>	<b>4</b>	<b>109</b>
Utilized	<b>(28)</b>	<b>(60)</b>	<b>(2)</b>	<b>(90)</b>
Balance at December 29, 2001	<b>\$ -</b>	<b>\$ 31</b>	<b>\$ 3</b>	<b>\$ 34</b>

The specific restructuring measures and associated estimated costs are based on Textron's best judgment under prevailing circumstances. Textron believes that the restructuring reserve balance of \$34 million is adequate to carry out the restructuring activities formally identified and committed to as of December 29, 2001 and anticipates that all actions related to these liabilities will be completed within a twelve-month period.

Restructuring costs and asset impairment charges recorded in earnings have been included in special charges, net on the consolidated statement of income. In 2001, Textron also incurred \$34 million in costs related to restructuring that have not been included in special charges, net. These expenses consist of costs for outsourcing certain operations in the Aircraft segment, plant rearrangement, machinery and equipment relocation, employee replacement and relocation costs, and are included in cost of sales and selling and administrative expenses within segment profit.

In 1999, Textron recorded severance of \$28 million and an asset impairment charge of \$14 million primarily related to cost reduction efforts in the Industrial Products segment designed to significantly reduce headcount by downsizing an underperforming plant in Europe, the announcement of the closing of seven facilities, and through targeted headcount reductions across most of its divisions. Textron also reversed \$24 million of reserves no longer deemed necessary after it was determined that certain projects would be cancelled. These actions were completed by December 30, 2000, with substantially all reserve spending occurring in 1999 and 2000.

#### **E-business Investment and Other**

During 2001, Textron recorded a \$6 million impairment charge related to its e-business securities and realized a \$3 million net loss on the sale of its remaining e-business securities. In 2000, Textron recorded an impairment charge of \$117 million related to these investment securities. These charges are included in special charges, net on the consolidated statement of income.

Special charges, net for 1999 include a gain of \$19 million as a result of shares granted to Textron from Manulife Financial Corporation's initial public offering on their demutualization of the Manufacturers Life Insurance Company.

## **15. Joint Ventures**

In the normal course of business, Textron has entered into various joint venture agreements. At December 29, 2001 and December 30, 2000, other assets includes \$37 million and \$29 million, respectively, attributable to investments in unconsolidated joint ventures. Textron accounts for its interest in these ventures under the equity method of accounting, and its equity in income (loss) from joint ventures for the three years ended December 29, 2001 is reported in cost of sales.

Textron has entered into an agreement with Agusta to share certain costs and profits for the joint design, development, manufacture, marketing, sale, customer training and product support of Bell Helicopter's BA609 and Agusta's AB139. These programs are currently in the development stage, and only certain marketing costs are being charged to the venture. Bell Helicopter's share of the development costs are being charged to earnings as a period expense. Bell Helicopter has also partnered with the Boeing Company in the development of the V-22 tiltrotor aircraft.

Textron has also entered into a joint venture with TAG Aviation USA, Inc. to sell fractional share interests in small business jets. During 2001 and 2000, Textron recorded revenue of \$38 million and \$26 million, respectively, for the sale of aircraft to this venture through arm's length transactions. Profit on these sales is initially deferred then recognized on a pro-rata basis as fractional share interests are sold to third parties. Textron has guaranteed one-half of the venture's debt and lease obligations up to a maximum of \$70 million. At December 29, 2001, Textron's portion of the outstanding debt and operating lease commitments covered by this guarantee totaled \$25 million.

While Textron has several other joint venture agreements that have external financing arrangements, Textron has only guaranteed approximately \$15 million in debt obligations related to these ventures.

## 16. Commitments, Contingencies and Environmental Remediation

### Commitments and Contingencies

Textron is subject to legal proceedings and other claims arising out of the conduct of Textron's business, relating to private transactions, government contracts, production partners, product liability, employment, and environmental, safety and health matters. Some of these legal proceedings and claims seek damages, fines or penalties in substantial amounts or remediation of environmental contamination. Under federal government procurement regulations, certain claims brought by the U.S. Government could result in Textron's suspension or debarment from U.S. Government contracting for a period of time. On the basis of information presently available, Textron believes that these proceedings and claims will not have a material effect on Textron's financial position or results of operations.

Cessna is a defendant in a previously-reported action filed in June 1991 in the Circuit Court in and for Escambia County, Florida, brought by certain individuals for injuries incurred in a 1989 crash of a Cessna 185 aircraft. In January 2002, the parties reached an agreement to settle this action. The amount of the settlement in excess of that which will be paid by Cessna's insurance carriers will be covered by pre-existing product liability reserves.

In the ordinary course of business, Textron enters into letters of credit and other similar arrangements with financial institutions. The letters of credit typically serve as a guarantee of payment or performance to certain third parties in accordance with specified terms and conditions. Management knows of no event of default that would require Textron to satisfy these guarantees at year-end 2001.

In addition to its financing relationship with Textron Finance, OmniQuip also utilizes third-party finance institutions to provide wholesale financing to certain of its customers. While these finance receivables are not reflected on Textron's balance sheet, the finance institutions generally have recourse to OmniQuip and may require OmniQuip to repurchase equipment related to customer defaults. The balance of this portfolio at December 29, 2001 and December 30, 2000 was \$57 million and \$43 million, respectively.

### Leases

Rental expense approximated \$103 million, \$101 million and \$94 million in 2001, 2000 and 1999, respectively. Future minimum rental commitments for noncancellable operating leases in effect at year-end 2001 approximated \$61 million for 2002; \$50 million for 2003; \$35 million for 2004; \$26 million for 2005; \$21 million for 2006; and a total of \$192 million thereafter.

### Environmental Remediation

Textron's accrued estimated environmental liabilities are based upon currently available facts, existing technology and presently enacted laws and regulations and are subject to a number of factors and uncertainties. Circumstances which can affect the accruals' reliability and precision include identification of additional sites, environmental regulations, level of cleanup required, technologies available, number and financial condition of other contributors to remediation, and the time period over which remediation may occur. Accrued liabilities relate to disposal costs, U.S. Environmental Protection Agency oversight costs, legal fees and operating and maintenance costs for both currently and formerly owned or operated facilities. Textron believes that any changes to the accruals that may result from these factors and uncertainties will not have a material effect on Textron's financial position or results of operations. Based upon information currently available, Textron estimates potential environmental liabilities to be in the range of \$50 million to \$160 million. At year-end 2001, environmental reserves of approximately \$93 million, of which \$15 million are classified as current liabilities, have been established to address these specific estimated potential liabilities. Textron estimates that its accrued environmental remediation liabilities will likely be paid over the next five to ten years.

## 17. Supplemental Financial Information

### Accrued Liabilities

Included in Textron Manufacturing's accrued liabilities at the end of 2001 and 2000 were the following:

<i>(In millions)</i>	<b>December 29, 2001</b>	December 30, 2000
Customer deposits	<b>\$ 279</b>	\$ 279
Reserve for warranties	<b>242</b>	236
Salaries, wages and employer taxes	<b>212</b>	260
Contract reserves	<b>113</b>	52
Other	<b>538</b>	544
Total accrued liabilities	<b>\$ 1,384</b>	\$ 1,371

### Research and Development Costs

Company-funded research and development costs include amounts for company-initiated programs, the cost sharing portions of customer-initiated programs, and losses incurred on customer-initiated programs. Textron also carries out research and development under contracts with others, primarily the U.S. Government. A significant portion of company-initiated programs include independent research and development related to government products and services which is recoverable through overhead cost allowances.

Company-funded and customer-funded research and development costs are as follows:

<i>(In millions)</i>	<b>2001</b>	2000	1999
Company-funded	<b>\$ 366</b>	\$ 307	\$ 257
Customer-funded	<b>323</b>	414	413
Total research and development	<b>\$ 689</b>	\$ 721	\$ 670

## 18. Segment Reporting

Textron has five reportable segments: Aircraft, Automotive, Fastening Systems, Industrial Products and Finance. See Note 1 for principal markets and major locations of Textron's segments.

Textron's reportable segments are strategically aligned based on the manner in which Textron manages its various operations. The accounting policies of the segments are the same as those described in the summary of significant accounting policies in Note 1. Textron evaluates segment performance based on segment profit. Segment profit for Textron Manufacturing excludes interest expense, certain corporate expenses, special charges and gains or losses from the disposition of significant business units. The Finance segment includes interest income, interest expense and distributions on preferred securities of Finance subsidiary trust as part of segment profit. Provisions for losses on finance receivables involving the sale or lease of Textron products are recorded by the selling manufacturing division.

The following summarizes the revenues by type of products:

<i>(In millions)</i>	<b>Revenues</b>		
	<b>2001</b>	2000	1999
Aircraft:			
Fixed-Wing Aircraft	<b>\$ 3,043</b>	\$ 2,814	\$ 2,472
Rotor Aircraft	<b>1,621</b>	1,580	1,547
Automotive:			
Trim	<b>1,579</b>	1,842	1,796
Fuel Systems and Functional Components	<b>1,022</b>	1,082	1,072
Fastening Systems	<b>1,679</b>	1,996	2,059
Industrial Products:			
Industrial Components and Other	<b>1,446</b>	1,693	1,131
Golf, Turf and Specialty Products	<b>738</b>	823	773
Fluid and Power	<b>484</b>	569	541
Finance	<b>709</b>	691	463
	<b>\$ 12,321</b>	\$ 13,090	\$ 11,854

The following tables and page 18 summarize selected financial information by segment:

<i>(In millions)</i>	Assets			Property, Plant and Equipment Expenditures		
	2001	2000	1999	2001	2000	1999
Aircraft	\$ 2,788	\$ 2,551	\$ 2,348	\$ 173	\$ 154	\$ 164
Automotive	706	1,738	1,800	165	127	132
Fastening Systems	1,537	1,776	1,970	61	108	103
Industrial Products	2,619	2,981	3,232	110	120	114
Finance	6,464	6,131	5,989	18	14	11
Corporate	4,119	3,339	1,743	5	4	8
Eliminations	(2,181)	(2,146)	(689)	-	-	-
	<b>\$ 16,052</b>	<b>\$ 16,370</b>	<b>\$ 16,393</b>	<b>\$ 532</b>	<b>\$ 527</b>	<b>\$ 532</b>

<i>(In millions)</i>	Amortization			Depreciation		
	2001	2000	1999	2001	2000	1999
Aircraft	\$ 11	\$ 10	\$ 10	\$ 115	\$ 105	\$ 97
Automotive	12	14	19	98	87	83
Fastening Systems	16	18	18	78	82	80
Industrial Products	57	45	32	86	87	73
Finance	22	15	7	19	17	12
Corporate	(4)	10	5	4	4	4
	<b>\$ 114</b>	<b>\$ 112</b>	<b>\$ 91</b>	<b>\$ 400</b>	<b>\$ 382</b>	<b>\$ 349</b>

### Geographic Data

Presented below is selected financial information by geographic area of Textron's operations:

<i>(In millions)</i>	Revenues*			Property, Plant and Equipment**		
	2001	2000	1999	2001	2000	1999
United States	\$ 8,022	\$ 8,569	\$ 7,540	\$ 1,502	\$ 1,791	\$ 1,718
Canada	692	798	710	78	127	118
Latin America and Mexico	826	790	738	45	121	68
Germany	613	584	694	183	165	187
Asia and Australia	518	603	441	12	13	14
United Kingdom	367	385	481	98	145	161
France	311	352	344	80	79	82
Other	972	1,009	906	90	164	165
	<b>\$ 12,321</b>	<b>\$ 13,090</b>	<b>\$ 11,854</b>	<b>\$ 2,088</b>	<b>\$ 2,605</b>	<b>\$ 2,513</b>

\*Revenues are attributed to countries based on the location of the customer.

\*\*Property, plant and equipment is based on the location of the asset.

Revenues include sales to the U.S. Government of \$1.2 billion in both 2001 and 2000 and \$1.3 billion in 1999. Revenues also include sales to DaimlerChrysler, primarily through the Automotive Trim business, of \$1.4 billion, \$1.5 billion and \$1.6 billion in 2001, 2000 and 1999, respectively.