MidWestOne Financial Group, Inc.
Form ANNLRPT
May 22, 2008

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ISB FINANCIAL CORP.

2007 ANNUAL REPORT

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To Our Shareholders:

Our annual report is being sent to you later than normal this year due to the recently completed merger of ISB Financial Corp. and MidWest*One* Financial Group, Inc. We normally reserve this space in our annual report to review in detail the prior year s financial results. Because we just recently mailed our first quarter report to you, we will use this space to talk about recent efforts to bring two fine companies together and to peer into the future of this newly formed banking company.

Iowa State Bank & Trust Company was formed in 1934 in Iowa City in the depths of the Great Depression by a group of investors that included Ben Summerwill. The Mahaska County State Bank was formed in Oskaloosa in 1883 by a group of investors that included Harry Howard. From these modest beginnings emerged a banking company that in 2008 is among the largest five banks based in Iowa.

ISB Financial Corp. and MidWest*One* Financial Group, Inc. announced their intent to join companies in a merger of equals on September 12, 2007. Regulatory approval was received and the companies officially merged on March 14, 2008. Although ISB Financial Corp. is the surviving corporation, the company s name has been changed to MidWest*One* Financial Group, Inc. The company owns three banks, Iowa State Bank & Trust Company in Iowa City, MidWest*One* Bank in Oskaloosa, and First State Bank in Conrad. Pending regulatory approval, we plan to merge the three banks into one bank in August of 2008. The resulting bank will have $1.5 billion in assets and span 21 communities and 29 locations in Southern and Eastern Iowa, with its headquarters in Iowa City.

We ve spent a lot of time talking to our primary four constituencies our customers, employees, shareholders, and the people in our communities since the merger announcement. As we ve often said, for any business to succeed, each of these four groups must be well served and we believe they will if we can execute our plans for the new company:

- Our customers will continue to see outstanding EDGE_ (Extraordinary Deeds through Genuine Efforts) service at each MidWest*One* location. To assure excellence, we will continue to measure our service quality and we will not waver in our commitment to deepen relationships with our customers. In addition, the new company should be able to better leverage technology and new products that will benefit our customers and differentiate us, over time, from our competitors in most of our markets.

- Our communities will continue to see the strong corporate citizen that they ve seen for many years. We are leaders in our communities. Our employees are leaders and our communities are better places because we are in them. This will not change.

- Our employees have more opportunities to shine and to perform on a bigger stage than ever before. We have a solid leadership team consisting of the top officers from the two companies. Our culture will be to pay for performance and to reward and recognize good work at every level of the company. We realize that we must provide an excellent workplace environment to attract and retain top-notch employees.

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Our shareholders are expected to have more liquidity than ever before with a NASDAQ traded stock. We believe that the efficiencies provided by the merger will provide our shareholders with a better earnings stream than could have been provided by either of the merged companies individually.

As we look out on the current banking landscape, we see opportunity as well as risk. Newspapers and magazines are full of stories that chronicle a weaker U.S. economy. We see signs of weakness in Iowa, but as we stated in our first quarter shareholder letter, Iowa seems to be faring somewhat better than the nation as a whole at this time. We saw some deterioration in our loan portfolios in the first quarter of 2008 as measured by past-due loans and charge-offs. At the end of the first quarter, the combined loan loss reserve of our three banks stood at 1.10% of total period-end loans and non-performing assets stood at 1.03% of loans. There are always surprises both pleasant and unpleasant when managing a loan portfolio. That said, we are confident in our ability to navigate the choppy seas in which we find ourselves at this time.

Capital and *liquidity* are two words that are on everyone s mind these days as the commercial banking system manages its way through the slowing economy. As of March 31, 2008, MidWest*One* Financial Group, Inc. had tangible equity to total assets of 8.50%. With an eye toward the unsettled markets experienced early in 2008, we have been building liquidity with the belief that a more liquid balance sheet would serve us well as 2008 unfolds. At March 31, our combined loan to deposit ratio stood at 93.07%. Our goal is to move this ratio into the mid to high 80 s over time.

We see great opportunity in delivering trust and investment services, as well as real estate mortgage services, in the MidWest*One* footprint. During 2008 and 2009, we will be seeking to add professionals in selected markets to provide these services to MidWest*One* customers. ISB Financial Corp. had been able to cross the 30% threshold in terms of fee income as a percentage of total revenues. While this number has fallen to the 25% range with the merger, we believe adding trust and investment representatives, as well as delivering a better product line of single family real estate mortgage loans, can propel our fee income toward the 30% level over the next few years.

To summarize, the goal for the next 12-18 months is to move our loan-to-deposit ratio into the 80 s, raise our non-interest income to total revenues toward 30%, and also to implement a disciplined approach to expense management. We believe that this path will produce a good and growing income stream for the company.

That brief financial blueprint, however, is only a part of the formula that will make MidWest*One* successful. Will we continue to give our customers competitive products and exceptional service? Will we continue to be leaders in the communities in which we have banks? Will we be able to be successful in our efforts to deepen customer relationships and our salespeople be able to attract customers to MidWest*One*? Will we be able to put together an energized staff, dedicated to assuring an affirmative answer to these questions?

This we know: your Board of Directors is committed to the notion that MidWest*One* Financial Group has the potential to be one of Iowa s banking leaders. We know that we see a growing core of key employees in our company who are dedicated to making the goals listed above a reality. We thank our directors and employees for all of their hard work over the past year. We look forward to sharing progress reports with you in our quarterly reports and in next year s annual report. As always, thank you for your investment in MidWest*One* and for your continued support.

Sincerely,

W. Richard Summerwill	Charles N. Funk
Chairman & CEO	President
ISB Financial Corp.	ISB Financial Corp.

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REPRESENTATIONS OF MANAGEMENT

Management is responsible for the content of the consolidated financial statements and supplemental information contained in other sections of this annual report. The consolidated financial statements have been prepared in conformity with generally accepted accounting principles appropriate to reflect, in all material respects, the substance of events and transactions that should be included. The consolidated financial statements reflect management s judgements and estimates as to the effects of events and transactions that are accounted for and disclosed.

The Company maintains accounting and reporting systems, supported by an internal accounting control system, which is adequate to provide reasonable assurance that transactions are authorized, assets are safeguarded and reliable financial statements are prepared, recognizing the cost and expected benefits of internal accounting controls. The internal auditor conducts ongoing reviews of accounting practices and internal accounting controls.

The consolidated financial statements of the Company and its subsidiaries are audited by independent certified public accountants. Their role is to render independent professional opinions on the fairness of the consolidated financial statements based upon performance of procedures they deem appropriate under auditing standards generally accepted in the United States of America.

The Audit Committee of the Board of Directors, composed solely of outside directors, meets periodically with the internal auditor and independent certified public accountants to review matters relating to internal accounting controls and the nature, extent and results of audit efforts. The internal auditor and independent certified public accountants have access to the Audit Committee.

W. Richard Summerwill
Chairman & CEO

Charles N. Funk
President

Gary J. Ortale
Treasurer

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors

ISB Financial Corp. and Subsidiaries

Iowa City, Iowa

We have audited the consolidated balance sheets of ISB Financial Corp. and Subsidiaries as of December 31, 2007 and 2006, and the related consolidated statements of income, shareholders   equity and cash flows for each of the three years in the period ended December 31, 2007. These financial statements are the responsibility of the Company   s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ISB Financial Corp. and Subsidiaries as of December 31, 2007 and 2006 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2007, in conformity with U.S. generally accepted accounting principles.

/s/ McGladrey & Pullen, LLP

Cedar Rapids, Iowa
March 13, 2008
McGladrey & Pullen, LLP is an independent member firm of RSM International,

an affiliation of separate and independent legal entities.

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ISB Financial Corp. and Subsidiaries

Consolidated Balance Sheets

December 31, 2007, and 2006

(In Thousands, Except Shares)

	2007	2006
Assets		
Cash and due from banks (Note 11)	**$ 16,378**	$ 14,274
Investment securities (Note 2):		
Available for sale (amortized cost 2007 $232,446; 2006 $241,926)	**232,125**	239,486
Held to maturity (fair value 2007 $101; 2006 $122)	**95**	113
Federal funds sold	**17,842**	3,175
Loans held for sale	**2,709**	2,422
Loans, net (Notes 3, 7, 12 and 13)	**396,088**	373,314
Property and equipment (Note 4)	**11,802**	12,090
Accrued interest receivable	**4,639**	4,568
Goodwill (Note 1)	**4,356**	4,356
Deferred income taxes (Note 8)	**1,836**	2,372
Bank-owned life insurance	**8,613**	8,157
Other assets	**5,500**	4,344
Total assets	**$ 701,983**	$ 668,671
Liabilities and Shareholders Equity		
Liabilities:		
Deposits:		
Noninterest-bearing demand	**$ 66,340**	$ 64,018
Savings and interest-bearing demand	**215,291**	199,148
Time (Notes 2 and 5)	**244,984**	229,735
Total deposits	**526,615**	492,901
Federal funds purchased		3,023
Securities sold under agreements to repurchase (Notes 2 and 7)	**45,997**	48,906
Federal Home Loan Bank borrowings (Note 7)	**47,000**	46,020
Accounts payable, accrued expenses and other liabilities	**4,979**	4,612
Total liabilities	**624,591**	595,462
Commitments and Contingencies (Note 12)		
Shareholders Equity (Notes 10 and 15)		
Capital stock, common, $1 par value; authorized 10,000,000 shares; issued 2007 5,165,308 shares; 2006 5,176,488 shares	**5,165**	5,176
Additional paid-in capital	**100**	14
Retained earnings	**72,333**	69,539
Accumulated other comprehensive (loss)	**(206)**	(1,520)
Total shareholders equity	**77,392**	73,209
Total liabilities and shareholders equity	**$ 701,983**	$ 668,671

See Notes to Consolidated Financial Statements.

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ISB Financial Corp. and Subsidiaries

Consolidated Statements of Income

Years Ended December 31, 2007, 2006 and 2005

(In Thousands, Except Per Share Amounts)

	2007	**2006**	**2005**
Interest income:			
Loans, including fees	**$ 27,564**	$ 25,850	$ 22,206
Investment securities:			
U.S. Treasury		15	74
U.S. Government agencies and corporations	**6,524**	6,570	5,897
State and political subdivisions	**2,912**	2,308	2,101
Other securities	**757**	282	128
Federal funds sold	**548**	283	221
Total interest income	**38,305**	35,308	30,627
Interest expense:			
Deposits:			
Savings and interest-bearing demand	**3,109**	3,042	1,791
Time	**11,689**	9,306	6,415
Total interest on deposits	**14,798**	12,348	8,206
Federal funds purchased and securities sold under agreements to repurchase	**2,114**	1,878	727
Other borrowings	**2,126**	2,533	2,809
Total interest expense	**19,038**	16,759	11,742
Net interest income	**19,267**	18,549	18,885
Provision for loan losses (Note 3)	**500**	550	300
Net interest income after provision for loan losses	**18,767**	17,999	18,585
Other income:			
Trust and investment fees	**3,688**	2,889	2,692
Service charges on deposit accounts	**2,082**	1,935	1,936
Income on sale of mortgage loans and servicing fees	**1,208**	963	1,207
Other service fees and commissions	**2,084**	1,893	2,565
Investment securities gains (losses), net (Note 2)	**(256)**	(108)	322
Total other income	**8,806**	7,572	8,722
Other expenses:			
Salaries and employee benefits (Notes 9 and 10)	**10,926**	10,081	10,053
Occupancy	**1,353**	1,291	1,245
Equipment	**1,625**	1,520	2,026
Office supplies, postage and telephone	**1,013**	960	1,099
Other	**3,703**	3,828	3,091

Total other expenses	**18,620**	17,680	17,514
Income before income taxes	**8,953**	7,891	9,793
Federal and state income taxes (Note 8)	**2,305**	2,093	2,876
Net income	**$ 6,648**	$ 5,798	$ 6,917
Earnings per share:			
Basic	**$ 1.29**	$ 1.11	$ 1.32
Diluted	**$ 1.29**	$ 1.11	$ 1.32

See Notes to Consolidated Financial Statements.

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ISB Financial Corp. and Subsidiaries

Consolidated Statements of Shareholders Equity

Years Ended December 31, 2007, 2006 and 2005

(In Thousands, Except Share Amounts)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2004	$ 1,741	$ 3,458	$ 61,223	$ (650)	$ 65,772
Comprehensive income:					
Net income			6,917		6,917
Change in net unrealized losses on securities available-for-sale, net of reclassification adjustment and tax effect (Note 1)				(2,363)	(2,363)
Total comprehensive income					4,554
Cash dividends paid ($0.85 per share)			(1,480)		(1,480)
Stock options exercised for 3,160 shares (Note 10)	3	114			117
Repurchase of 60 shares of common stock		(4)			(4)
Balance, December 31, 2005	1,744	3,568	66,660	(3,013)	68,959
Comprehensive income:					
Net income			5,798		5,798
Change in net unrealized losses on securities available-for-sale, net of reclassification adjustment and tax effect (Note 1)				1,493	1,493
Total comprehensive income					7,291
Cash dividends paid ($0.95 per share)			(1,657)		(1,657)
Stock options exercised for 4,630 shares (Note 10)	5	78			83
Stock compensation		1			1
Repurchase of 26,683 shares of common stock	(27)	(1,260)	(181)		(1,468)
Stock split, 3,454,066 shares issued (Note 15)	3,454	(2,373)	(1,081)		
Balance, December 31, 2006	5,176	14	69,539	(1,520)	73,209

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ISB Financial Corp. and Subsidiaries

Consolidated Statements of Shareholders   Equity (Continued)

Years Ended December 31, 2007, 2006 and 2005

(In Thousands, Except Share Amounts)

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2006	$ 5,176	$ 14	$ 69,539	$ (1,520)	$ 73,209
Comprehensive income:					
Net income			6,648		6,648
Change in net unrealized losses on securities available-for-sale, net of reclassification adjustment and tax effect (Note 1)				1,314	1,314
Total comprehensive income					7,962
Cash dividends paid ($0.65 per share)			(3,359)		(3,359)
Stock options exercised for 8,425 shares (Note 10)	8	99			107
Stock compensation		2			2
Repurchase of 19,605 shares of common stock	(19)	(15)	(495)		(529)
Balance, December 31, 2007	**$ 5,165**	**$ 100**	**$ 72,333**	**$ (206)**	**$ 77,392**

See Notes to Consolidated Financial Statements.

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ISB Financial Corp. and Subsidiaries

Consolidated Statements of Cash Flows

Years Ended December 31, 2007, 2006 and 2005

(In Thousands)

	2007	2006	2005
Cash Flows from Operating Activities			
Net income	**$ 6,648**	$ 5,798	$ 6,917
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	**1,325**	1,251	1,489
Amortization		15	19
Provision for loan losses	**500**	550	300
Deferred income taxes	**(269)**	24	(157)
Stock option expense	**2**	1	
Investment securities (gains) losses	**256**	108	(322)
Originations of loans held for sale	**(74,032)**	(61,108)	(71,570)
Proceeds from loans held for sale	**73,745**	59,975	73,573
Net change in:			
(Increase) in accrued interest receivable	**(71)**	(533)	(464)
Decrease (increase) in other assets	**(1,156)**	1,672	(740)
Increase in accounts payable, accrued expenses and other liabilities	**367**	1,131	181
Net cash provided by operating activities	**7,315**	8,884	9,226
Cash Flows from Investing Activities			
Available for sale securities:			
Sales	**28,774**	8,519	20,557
Maturities	**64,409**	48,257	60,217
Purchases	**(83,959)**	(56,838)	(66,043)
Maturities of held to maturity securities	**18**	62	67
Federal funds sold, net	**(14,667)**	11,325	(7,463)
Loans made to customers, net of collections	**(23,274)**	(8,301)	(35,284)
Purchase of property and equipment, net	**(1,037)**	(1,283)	(2,385)
Activity in bank-owned life insurance:			
Purchases	**(118)**	(61)	(5,000)
(Increase) in cash value	**(338)**	(316)	(283)
Net cash provided by (used in) investing activities	**(30,192)**	1,364	(35,617)
Cash Flows from Financing Activities			
Net increase in deposits	**33,714**	320	18,022
Net (decrease) increase in federal funds purchased and securities sold under agreements to repurchase	**(5,932)**	6,881	13,966
Proceeds from Federal Home Loan Bank borrowings	**28,995**	12,770	13,500
Repayment of Federal Home Loan Bank borrowings	**(28,015)**	(26,450)	(14,800)
Stock options exercised	**107**	83	117
Repurchase of common stock	**(529)**	(1,468)	(4)
Dividends paid	**(3,359)**	(1,657)	(1,480)
Net cash provided by (used in) financing activities	**24,981**	(9,521)	29,321

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ISB Financial Corp. and Subsidiaries

Consolidated Statements of Cash Flows (Continued)

Years Ended December 31, 2007, 2006 and 2005

(In Thousands)

	2007	2006	2005
Increase in cash and due from banks	**$ 2,104**	$ 727	$ 2,930
Cash and Due From Banks:			
Beginning balance	**14,274**	13,547	10,617
Ending balance	**$ 16,378**	$ 14,274	$ 13,547
Supplemental Disclosures			
Cash payments for:			
Interest paid to depositors	**$ 14,969**	$ 11,721	$ 7,776
Interest paid on other obligations	**4,254**	4,429	3,541
Income taxes	**2,572**	1,645	2,953

See Notes to Consolidated Financial Statements.

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ISB FINANCIAL CORP. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 1. Nature of Business and Significant Accounting Policies

Nature of business: ISB Financial Corp. and Subsidiaries (the Company) is a bank holding company that owns 100% of the outstanding common stock of Iowa State Bank & Trust Company, Iowa City and 100% of the common stock of First State Bank, Conrad, Iowa. Iowa State Bank & Trust Company and First State Bank (collectively the Banks) provide services to individuals, businesses, governmental units and institutional customers in Johnson County, Iowa, West Liberty, Iowa, and within a territory approximately 20 miles from Conrad, Melbourne and Parkersburg, Iowa. The Banks are actively engaged in many areas of commercial banking, including: acceptance of demand, savings and time deposits; making commercial, real estate, agricultural and consumer loans, and other banking services tailored for its individual customers. The Investment and Trust Department of Iowa State Bank & Trust Company administers estates, personal trusts, conservatorships, pension and profit-sharing accounts along with providing other management services to customers.

Accounting estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Certain significant estimates: The allowance for loan losses, unrealized gains and losses on debt securities available for sale, annual impairment testing of goodwill, estimated discount rate and expected long-term rate of return used in actuarial determination of pension plan asset or liability, and the fair values of investment securities and other financial instruments involve certain significant estimates made by management. These estimates are reviewed by management routinely and it is reasonably possible that circumstances that exist may change in the near-term future and that the effect could be material to the financial statements.

Principles of consolidation: The consolidated financial statements include the accounts of the Company and its subsidiary banks. All significant inter-company accounts and transactions have been eliminated in consolidation.

Presentation of cash flows: For purposes of reporting cash flows, cash and due from banks includes cash on hand and amounts due from banks (including cash items in process of clearing). Cash flows from loans originated by the Banks, deposits and federal funds purchased and sold and securities sold under agreements to repurchase are reported net.

Reclassification: Certain amounts in the 2006 consolidated financial statements have been reclassified to conform to the 2007 presentation.

Investment securities: Certain debt securities that the Company has the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Securities not classified as held to maturity, including equity securities with readily determinable fair values, are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost, that are deemed to be other than temporary, are reflected in earnings as realized losses. In determining whether other than temporary impairment exists, management considers: (1) the length of time and the extent of which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Loans: Loans that the Banks have the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding unpaid principal balances adjusted for charge-offs and the allowance for loan losses. Interest income is accrued on the unpaid principal balance.

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ISB FINANCIAL CORP. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 1. Nature of Business and Significant Accounting Policies (Continued)

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90-days past due, unless the credit is well secured and in process of collection. Credit card loans and other personal loans are typically charged off no later than 180-days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date, if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Loans held for sale: Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or estimated fair value, as determined by aggregate outstanding commitments from investors or current investor yield requirements. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income.

Mortgage loans held for sale are generally sold with the mortgage servicing rights released. Gains or losses on sales of mortgage loans with servicing released are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold.

Allowance for loan losses: The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a quarterly basis by management and is based upon management s periodic review of the collectiblity of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers nonclassified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management s estimate of probable losses. The unallocated component of the allowance reflects that margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that the Banks will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include: payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower s prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial, construction and commercial real estate loans by either the present value of expected future cash flows discounted at the loan s effective interest rate, the loan s obtainable market price or the fair value of the collateral, if the loan is collateral dependent.

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ISB FINANCIAL CORP. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 1. Nature of Business and Significant Accounting Policies (Continued)

Large groups of smaller-balance, homogeneous loans are collectively evaluated for impairment. Accordingly, the Banks do not separately identify individual consumer and residential loans for impairment disclosures.

Transfers of financial assets: Revenue from the origination and sale of loans in the secondary market is recognized upon the transfer of financial assets and accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from the Banks, (2) the transferee has the right to pledge or exchange the assets it received and no condition both constrains the transferee from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor and (3) the Banks do not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

Revenue recognition: Trust fees, deposit account service charges and other fees are recognized when the services are provided or when customers use the services.

Credit-related financial instruments: In the ordinary course of business, the Banks have entered into commitments to extend credit, including commitments under credit card arrangements, commercial letters of credit and standby letters of credit. Such financial instruments are recorded when they are funded.

Property and equipment: Property and equipment are stated at cost less accumulated depreciation. The estimated useful lives and primary method of depreciation for the principal items are as follows:

Type of Assets	**Years**	**Depreciation Method**
Buildings and leasehold improvements	10 30	Straight-line
Furniture and equipment	3 10	Straight-line

Other real estate owned: Real estate parcels acquired in satisfaction of loans are included in other assets at the lower of cost or fair value less estimated costs of disposal. When a property is acquired, the excess of the recorded investment in the property over its estimated fair value, less estimated costs of disposal, if any, is charged to the allowance for loan losses. Subsequent declines in the estimated fair value are recorded in a valuation allowance account. Additions to or reductions from valuation allowances, along with net operating results of the property, are included in other operating expenses. There was no balance as of December 31, 2007 and 2006.

Bank-owned life insurance: Bank-owned life insurance is carried at cash surrender value with increases/decreases reflected as income/expense in the statement of income.

Employee benefit plans: Annual expense of a defined benefit pension plan includes service cost (measured by projected unit credit method), interest on the projected benefit obligation, actual return on plan assets and other amortization and deferred amounts specified by Financial Accounting Standards Board Statements No. 87 and No. 158.

Deferred benefits under a salary continuation plan are charged to expense during the period the participating employees attain full eligibility.

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ISB FINANCIAL CORP. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 1. Nature of Business and Significant Accounting Policies (Continued)

Stock-based compensation: The Company adopted SFAS No. 123(R) on January 1, 2006 using the prospective method in which compensation cost is recognized over the service period for all awards granted subsequent to the Company s adoption of SFAS No. 123(R). Prior to the adoption of SFAS No. 123(R), the Company accounted for stock-based compensation under the intrinsic value method, as outlined under the provisions of Accounting Principles Board Opinion No. 25 and its related interpretations. Accordingly, no compensation cost was recognized for grants issued prior to the adoption of SFAS No. 123(R) since the options were granted with an exercise price equal to market value at the date of grant.

Income taxes: The Company files a consolidated federal income tax return. Income tax expense is generally allocated as if the Holding Company and its subsidiaries file separate income tax returns. Deferred taxes are provided on an asset and liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carryforwards and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

When tax returns are filed, it is highly certain that some positions taken will be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. The evaluation of a tax position taken is considered by itself and not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority.

Interest and penalties related to income taxes are recorded as miscellaneous expense in the statements of income.

Earnings per share: Basic per-share amounts are computed by dividing net income (the numerator) by the weighted-average number of common shares outstanding (the denominator). Diluted per share amounts assume the conversion, exercise or issuance of all potential common stock, unless the effect is to reduce the loss or increase the income per common share from continuing operations.

Following is a reconciliation of the denominator:

	Year Ended December 31,		
	2007	**2006**	**2005**
Weighted-average number of shares	**5,170,898**	5,204,957	5,228,775
Potential number of dilutive shares	**1,660**	8,921	8,378
Total shares to compute diluted earnings per share	**5,172,558**	5,213,878	5,237,153

There are no potentially dilutive securities that have not been included in the determination of diluted shares.

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ISB FINANCIAL CORP. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 1. Nature of Business and Significant Accounting Policies (Continued)

Goodwill: Goodwill represents the cost in excess of the fair value of assets acquired in business combinations. Goodwill has an indefinite life, but is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. The Company established September 30 as the date for its annual impairment test. The annual impairment test consists of a comparison of the fair value of the intangible asset to its carrying amount. If the carrying amount were to exceed the fair value, an impairment loss would be recognized. The Company has completed the annual impairment test and concluded there was no impairment as of September 30, 2007, 2006 and 2005.

Trust assets: Trust assets, other than cash deposits held by the Banks in fiduciary or agency capacities for its customers, are not included in the accompanying financial statements because such accounts are not assets of the Banks.

Comprehensive income: Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

The components of other comprehensive income and related tax effects are as follows:

	Year Ended December 31,		
	2007	**2006**	**2005**
		(In Thousands)	
Unrealized holding gains (losses) on available for sale securities	**$ 1,863**	$ 2,266	$ (3,447)
Reclassification adjustment for (gains) losses realized in income	**256**	108	(322)
	2,119	2,374	(3,769)
Tax effects	**805**	881	(1,406)
Other comprehensive income (loss)	**$ 1,314**	$ 1,493	$ (2,363)

The components of accumulated other comprehensive income, included in shareholders equity, are as follows:

	Year Ended December 31,		
	2007	**2006**	**2005**
		(In Thousands)	
Net unrealized (losses) on securities available for sale	**$ (321)**	$ (2,440)	$ (4,814)
Tax effects	**(115)**	(920)	(1,801)
Accumulated other comprehensive income (loss)	**$ (206)**	$ (1,520)	$ (3,013)

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ISB FINANCIAL CORP. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 1. Nature of Business and Significant Accounting Policies (Continued)

Recent Accounting Pronouncements: In September 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS No. 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurement. SFAS No. 157 also emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted in active markets. Under SFAS No. 157, fair value measurements are disclosed by level within that hierarchy. The requirements of FAS 157 are first effective for our fiscal year beginning January 1, 2008. However, in February 2008, the FASB decided that an entity need not apply this standard to nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis until the subsequent year. Accordingly, our adoption of this standard on January 1, 2008 is limited to financial assets and liabilities, and any nonfinancial assets and liabilities recognized or disclosed at fair value on a recurring basis. The Company is currently assessing the potential effect of SFAS No. 157 on its financial position, results of operations and cash flows.

In February 2007, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* , which provides all entities, including not-for-profit organizations, with an option to report selected financial assets and liabilities at fair value. The objective of the Statement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in earnings caused by measuring related assets and liabilities differently without having to apply the complex provisions of hedge accounting. Certain specified items are eligible for the irrevocable fair value measurement option as established by Statement No. 159. Statement No. 159 is effective as of the beginning of an entity s first fiscal year beginning after November 15, 2007. The Company is currently evaluating the impact that the adoption of this Statement will have on its financial position, results of operation and cash flows.

In September 2006, the Emerging Issues Task Force (EITF) reached a final consensus on Issue 06-04, Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements. The consensus stipulates that an agreement by an employer to share a portion of the proceeds of a life insurance policy with an employee during the postretirement period is a postretirement benefit arrangement required to be accounted for under SFAS No. 106 or Accounting Principles Board Opinion (APB) No. 12, Omnibus Opinion 1967. The consensus concludes that the purchase of a split-dollar life insurance policy does not constitute a settlement under SFAS No. 106 and, therefore, a liability for the postretirement obligation must be recognized under SFAS No. 106 if the benefit is offered under an arrangement that constitutes a plan or under APB No. 12 if it is not part of a plan. Issue 06-04 is effective for annual or interim reporting periods beginning after December 15, 2007. The Company has endorsement split-dollar life insurance policies and is currently assessing the financial statement impact of implementing EITF 06-04.

In March 2007, the Emerging Issues Task Force (EITF) reached a final conclusion on Issue 06-10, Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements . The consensus concludes that a liability must be recognized for the postretirement obligation related to a collateral assignment split-dollar life insurance arrangement in accordance with SFAS No. 106 or APB No. 12. Any asset should be recognized and measured based on the nature and substance of the collateral assignment split-dollar life insurance arrangement. The effective date of EITF 06-10 is for fiscal years beginning after December 15, 2007. The Company is currently assessing the financial statement impact of implementing EITF 06-10.

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ISB FINANCIAL CORP. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 1. Nature of Business and Significant Accounting Policies (Continued)

In December 2007, FASB issued SFAS No. 141(revised), *Business Combinations*. The Statement establishes principles and requirements for how an acquirer recognizes and measures tangible assets acquired, liabilities assumed, goodwill and any noncontrolling interests and identifies related disclosure requirements for business combinations. Measurement requirements will result in all assets, liabilities, contingencies and contingent consideration being recorded at fair value on the acquisition date, with limited exceptions. Acquisition costs and restructuring costs will generally be expensed as incurred. This Statement is effective for the Company for business combinations in which the acquisition date is on or after January 1, 2009.

Note 2. Investment Securities

The amortized cost and fair value of investment securities available for sale, with gross unrealized gains and losses, are as follows:

	(In Thousands)			
	Amortized Cost	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
December 31, 2007:				
U.S. Government agencies and corporations	**$ 65,937**	**$ 1,013**	**$ (59)**	**$ 66,891**
State and political subdivisions	**82,876**	**299**	**(763)**	**82,412**
Mortgage-backed and collateralized mortgage obligations	**69,079**	**374**	**(325)**	**69,128**
Other securities	**14,554**	**368**	**(1,228)**	**13,694**
Total	**$ 232,446**	**$ 2,054**	**$ (2,375)**	**$ 232,125**
December 31, 2006:				
U.S. Government agencies and corporations	$ 86,329	$ 113	$ (980)	$ 85,462
State and political subdivisions	70,357	199	(812)	69,744
Mortgage-backed and collateralized mortgage obligations	78,249	25	(1,301)	76,973
Other securities	6,991	337	(21)	7,307
Total	$ 241,926	$ 674	$ (3,114)	$ 239,486

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ISB FINANCIAL CORP. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 2. Investment Securities (Continued)

The amortized cost and fair value of investment securities held-to-maturity, with gross unrealized gains and losses, are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(In Thousands)		
December 31, 2007:				
State and political subdivisions	**$ 95**	**$ 6**	**$**	**$ 101**
December 31, 2006:				
State and political subdivisions	$ 113	$ 9	$	$ 122

Investment securities with a carrying value of $76,885,000 and $71,828,000 at December 31, 2007 and 2006, respectively, were pledged on public deposits, securities sold under agreements to repurchase and for other purposes, as required or permitted by law.

Gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are summarized as follows:

December 31, 2007:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
			(In Thousands)			
Securities available for sale:						
U.S. Government agencies	**$**	**$**	**$ 11,939**	**$ 59**	**$ 11,939**	**$ 59**
State and political subdivisions	**12,016**	**178**	**33,220**	**585**	**45,236**	**763**
Mortgage-backed and collateralized mortgage obligations			**30,956**	**325**	**30,956**	**325**
Other securities	**8,617**	**1,066**	**239**	**162**	**8,856**	**1,228**
	$ 20,633	**$ 1,244**	**$ 76,354**	**$ 1,131**	**$ 96,987**	**$ 2,375**

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ISB FINANCIAL CORP. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 2. Investment Securities (Continued)

December 31, 2006:

	Less than 12-Months		12-Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
			(In Thousands)			
Securities available for sale:						
U.S. Government agencies	$ 24,803	$ 84	$ 50,679	$ 896	$ 75,482	$ 980
State and political subdivisions	11,950	109	37,039	703	48,989	812
Mortgage-backed and collateralized mortgage obligations	18,741	107	55,021	1,194	73,762	1,301
Other securities	380	21			380	21
	$ 55,874	$ 321	$ 142,739	$ 2,793	$ 198,613	$ 3,114

In reaching the conclusion that the impairments disclosed above are temporary and not other-than-temporary, the Company evaluates the nature of the U.S. Treasury Securities, U.S. Government agency securities, mortgage-backed and collateralized mortgage obligations, and other securities, and the credit ratings of the state and municipal bonds. None of the impairment was due to the deterioration in credit quality of the issuers that might result in the non-collection of principal and interest. The cause of the impairments is due to changes in interest rates and the Company has not recognized any unrealized loss in income because the Company has the intent and ability to hold these investment securities for a period of time sufficient to allow for an anticipated recovery.

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ISB FINANCIAL CORP. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 2. Investment Securities (Continued)

The contractual maturity distribution of investment securities at December 31, 2007 is summarized as follows:

	(In Thousands)			
	Available-For-Sale		**Held-To-Maturity**	
	Amortized Cost	**Fair Value**	**Amortized Cost**	**Fair Value**
Due in one year or less	$ 33,880	$ 33,857	$	$
Due after one year through five years	68,392	68,956	95	101
Due after five years through ten years	39,063	39,161		
Due after ten years	19,252	18,395		
Mortgage-backed and collateralized mortgage obligations	69,079	69,128		
	$ 229,666	$ 229,497	$ 95	$ 101

Mortgage-backed and collateralized mortgage obligations are collateralized by mortgage loans guaranteed by U.S. Government agencies. Experience has indicated that principal payments will be collected sooner than scheduled because of prepayments. Therefore, these securities are not scheduled in the maturity categories indicated above. Other equity securities available for sale with an amortized cost of $2,780,000 and a fair value of $2,628,000 are excluded from this table.

Realized gains and losses on sales of investment securities are as follows:

	Year Ended December 31,		
	2007	**2006**	**2005**
	(In Thousands)		
Gross gains	**$ 45**	$ 50	$ 363
Gross losses	**(301)**	(158)	(41)
	$ (256)	$ (108)	$ 322

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ISB FINANCIAL CORP. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 3. Loans

The composition of the net loans is as follows:

	December 31, 2007	December 31, 2006
	(In Thousands)	
Commercial, financial and agricultural	**$ 103,029**	$ 89,284
Real estate:		
Construction	**28,774**	31,133
Mortgage	**260,201**	248,308
Loans to individuals	**8,895**	9,475
All other	**655**	412
Total loans	**401,554**	378,612
Less allowance for loan losses	**5,466**	5,298
Net loans	**$ 396,088**	$ 373,314

Changes in the allowance for loan losses are as follows:

	Year Ended December 31, 2007	2006	2005
		(In Thousands)	
Balance, beginning	**$ 5,298**	$ 5,227	$ 4,894
Provision charged to operating expenses	**500**	550	300
Recoveries of amounts charged-off	**148**	103	208
Loans charged-off	**(480)**	(582)	(175)
Balance, ending	**$ 5,466**	$ 5,298	$ 5,227

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ISB FINANCIAL CORP. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 3. Loans (Continued)

Information about impaired and nonaccrual loans, as of and for the years ended December 31, 2007 and 2006, is as follows:

	2007	2006
	(In Thousands)	
Loans for which there is a related allowance for loan losses	**$ 3,154**	$ 1,594
Loans for which there is no related allowance for loan losses		
Total impaired loans	**$ 3,154**	$ 1,594
Allowance for loan losses on impaired loans	**$ 693**	$ 331
Average balance of impaired loans	**2,374**	2,335
Nonaccrual loans	**782**	371
Loans past due 90-days or more and still accruing interest	**517**	395
Interest income recognized on impaired loans	**245**	124

Note 4. Property and Equipment
Property and equipment is as follows:

	December 31,	
	2007	2006
	(In Thousands)	
Land	**$ 2,428**	$ 2,428
Buildings and leasehold improvements	**11,535**	11,545
Furniture and equipment	**9,180**	8,421
	23,143	22,394
Accumulated depreciation and amortization	**11,341**	10,304
	$ 11,802	$ 12,090

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ISB FINANCIAL CORP. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Note 5. Certificates of Deposit

Certificates of deposit in denominations of $100,000 or more totaled $77,939,000 and $70,230,000 at December 31, 2007 and 2006, respectively.

At December 31, 2007, the scheduled maturities of certificates of deposits (in thousands) are as follows:

2008	$ 212,802
2009	25,685
2010	3,033
2011	1,087
2012	2,377
	$ 244,984

Note 6. Loans Serviced for Others

Loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of mortgage and other loans serviced for others were $96,866,000 and $107,990,000 at December 31, 2007 and 2006, respectively.