Bill of Exchange Definition: Examples and How It Works

What Is a Bill of Exchange?

A bill of exchange is a written order used primarily in international trade that binds one party to pay a fixed sum of money to another party on demand or at a predetermined date. Bills of exchange are similar to checks and promissory notes—they can be drawn by individuals or banks and are generally transferable by endorsements.

A bill of exchange must clearly detail the amount of money, the date, and the parties involved including the drawer and drawee. If a bill of exchange is issued by a bank, it can be referred to as a bank draft. The issuing bank guarantees payment on the transaction.

KEY TAKEAWAYS

- A bill of exchange is a written order binding one party to pay a fixed sum of money to another party on demand or at some point in the future.
- A bill of exchange often includes three parties—the drawee is the party that pays the sum, the payee receives that sum, and the drawer is the one that obliges the drawee to pay the payee.
- A bill of exchange is used in international trade to help importers and exporters fulfil transactions.
- While a bill of exchange is not a contract itself, the involved parties can use it to specify the terms of a transaction, such as the credit terms and the rate of accrued interest.

Understanding Bills of Exchange

A bill of exchange transaction can involve up to three parties. The drawee is the party that pays the sum specified by the bill of exchange. The payee is the one who receives that sum. The drawer is the party that obliges the drawee to pay the payee. The drawer and the payee are the same entity unless the drawer transfers the bill of exchange to a third-party payee.
Unlike a check, however, a bill of exchange is a written document outlining a debtor's indebtedness to a creditor. It's frequently used in international trade to pay for goods or services. While a bill of exchange is not a contract itself, the involved parties can use it to fulfil the terms of a contract. It can specify that payment is due on demand or at a specified future date. It's often extended with credit terms, such as 90 days. As well, a bill of exchange must be accepted by the drawee to be valid.

Bills of exchange generally do not pay interest, making them in essence post-dated checks. They may accrue interest if not paid by a certain date, however, in which case the rate must be specified on the instrument. They can, conversely, be transferred at a discount before the date specified for payment. A bill of exchange must clearly detail the amount of money, the date, and the parties involved including the drawer and drawee.

If a bill of exchange is issued by a bank, it can be referred to as a bank draft. The issuing bank guarantees payment on the transaction. If bills of exchange are issued by individuals, they can be referred to as trade drafts. If the funds are to be paid immediately or on-demand, the bill of exchange is known as a sight draft. In international trade, a sight draft allows an exporter to hold title to the exported goods until the importer takes delivery and immediately pays for them. However, if the funds are to be paid at a set date in the future, it is known as a time draft. A time draft gives the importer a short amount of time to pay the exporter for the goods after receiving them.

The difference between a promissory note and a bill of exchange is that the latter is transferable and can bind one party to pay a third party that was not involved in its creation. Banknotes are common forms of promissory notes. A bill of exchange is issued by the creditor and orders a debtor to pay a particular amount within a given period of time. The promissory note, on the other hand, is issued by the debtor and is a promise to pay a particular amount of money in a given period.

Example of Bill of Exchange

Say Company ABC purchases auto parts from Car Supply XYZ for $25,000. Car Supply XYZ draws a bill of exchange, becoming the drawer and payee in this case. The bill of exchange stipulates that Company ABC will pay Car Supply XYZ $25,000 in 90 days. Company ABC becomes the drawee and accepts the bill of exchange and the goods are shipped. In 90 days, Car Supply XYZ will present the bill of exchange to Company ABC for payment. The bill of exchange was an acknowledgment created by Car Supply XYZ, which was also the creditor in this case, to show the indebtedness of Company ABC, the debtor.

What Are Some Differences Between a Bill of Exchange and a Cheque?

A check always involves a bank while a bill of exchange can involve anyone, including a bank. Checks are payable on demand while a bill of exchange can specify that payment is due on demand or at a specified future date. Bills of exchange generally do not pay interest, making them in essence post-dated checks. They may accrue interest if not paid by a certain date, but that rate must be specified on the instrument. Unlike a check, a bill of exchange is a written document outlining a debtor's indebtedness to a creditor.

Who Are the Parties to a Bill of Exchange?

A bill of exchange transaction can involve up to three parties. The drawee is the party that pays the sum specified by the bill of exchange. The payee is the one who receives that sum. The drawer is the party that obliges the drawee to pay the payee. The drawer and the payee are the same entity unless the drawer transfers the bill of exchange to a third-party payee.

What Are the Different Types of Bills of Exchange?

A bill of exchange issued by a bank is referred to as a bank draft. The issuing bank guarantees payment on the transaction. A bill of exchange issued by individuals is referred to as a trade draft. If the funds are to be paid immediately or on-demand, the bill of exchange is known as a sight draft. In international trade, a sight draft allows an exporter to hold title to the exported goods until the importer takes delivery and immediately pays for them. However, if the funds are to be paid at a set date in the future, it is known as a time draft which gives the importer a short amount of time to pay the exporter for the goods after receiving them.

What's the Difference Between Bill of Exchange and Promissory Note?

The difference between a promissory note and a bill of exchange is that the latter is transferable and can bind one party to pay a third party that was not involved in its creation. Banknotes are common forms of promissory notes. A bill of exchange is issued by the creditor and orders a debtor to pay a particular amount within a given period of time. The promissory note, on the other hand, is issued by the debtor and is a promise to pay a particular amount of money in a given period.